HOLMES

FEDERAL INCOME AND PROFITS TAXES

FEDERAL
INCOME TAX
WAR-PROFITS AND EXCESS-PROFITS TAXES

INCLUDING

STAMP TAXES
CAPITAL STOCK TAX
TAX ON EMPLOYMENT OF CHILD LABOR
TAX ON UNDISTRIBUTED PROFITS

BY

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CHICAGO
CALLAGHAN AND COMPANY
1919

PREFACE

In the short time which has elapsed since the appearance of the first edition of this book a great development has taken place in our system of income taxation. The Revenue Act of 1918 is a remarkable improvement in form and in substance over the former law. But improvement is to be found not only in the statute. The Treasury Department has made vast strides in administrative progress. In the stress of collecting revenues at rates so high that they fairly threatened the solvency of many taxpayers, old departmental customs have been changed and old rules discarded. A new, more efficient, and withal a fairer, system of collecting revenue has been evolved. In a year of great deeds, the achievement of the Commissioner of Internal Revenue and his able assistants is worthy of unqualified admiration. The language of the regulations reflects the new order, in its expression of a firm but reasonable and thoughtful purpose to exact from each taxpayer what the law requires—an expression which will no doubt have pronounced psychological effect on the great body to which it is addressed. The tax burden of the present is tremendous, but taxpayers may rest assured that while it will be placed where the law indicates, it will be placed carefully, intelligently and with due consideration of the merits of each case.

The author has been under no inconsiderable stress in the preparation of the present edition of this book, since less than a month has elapsed between the passage of the law and the day it must go to press to be of timely value; and less than three weeks have elapsed since the issuance

of the new regulations and forms. Necessarily the book will have its shortcomings, but it is the belief of the author that all the rulings and regulations bearing upon the 1918 Revenue Law will be found therein, together with such rulings and regulations under former laws as are necessary to a proper understanding of the present law and those which immediately preceded it. Any criticism of the book or suggestions for its improvement will be gratefully received.

The author's thanks are extended to the many friends who have given him helpful suggestions and criticism in preparing the work, and particularly to Mr. Randolph E. Paul, of the New York and the New Jersey Bar, and Mr. H. B. Spaulding, for their assistance in the preparation of the manuscript. The author's thanks are again extended to the Corporation Trust Company of New York for the use of those invaluable sources of information, its Income Tax Service and War Tax Service. These Services are so generally recognized as the standard reporters of the Treasury rulings that reference is freely made to them as sources of authority. They are cited "I. T. S." and "W. T. S." respectively in the footnotes.

GEORGE E. HOLMES.

New York, March 15, 1919.

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FEDERAL INCOME TAX

CHAPTER 1

INTRODUCTION [1]

The Federal Income Tax is now imposed by Title II [2] and the War Profits and Excess Profits taxes by Title III of the comprehensive Revenue Act of 1918.[3] This Act (referred to in this book as the Revenue Act of 1918, the 1918 Law or the present law) was introduced into Congress during the war with Germany, and many of its provisions are definitely a reflection of the exigencies of the times. The rates of tax are higher than those imposed under any preceding law. The law provides for a reduction of the normal tax in the case of individuals and the income and the excess-profits taxes in the case of corporations for the year 1919 and subsequent years. Several provisions of a remedial nature are contained in the law by means of which losses not strictly ascertained in 1918 may nevertheless be applied against the 1918 income. The

1 The purpose of this chapter is to describe briefly the salient provisions and requirements of the law and the system of administration, so that the reader may obtain a general understanding of the subject before the various provisions are taken up and discussed in detail.

2 Title I of the same act contains definitions applicable to the titles following, and must be consulted in connection with Title II.

3 The Act is entitled "An Act to provide revenue, and for other purposes," and may be cited as the "Revenue Act of 1918." See Section 1404.

1865, amending the Act of June 30, 1864, Act of March 2, 1867, and the Act of July 14, 1870. In 1871 the last of the Civil War income tax acts expired and was not re-enacted. No further attempt was made to collect income taxes by the Federal Government until the Act of August 28, 1894, which was held unconstitutional on the ground that incomes from real property could not be taxed without apportionment. As a result, the 16th Amendment expressly authorized the imposition of a tax on income from all sources without apportionment and without regard to any census or enumeration.

Administration of the Laws. The duty of administering the income tax laws and collecting the taxes thereunder is imposed on the Bureau of Internal Revenue, which is a part of the Federal Treasury Department. The bureau is under the charge of the Commissioner of Internal Revenue (referred to herein as the Commissioner), who, under the direction of the Secretary (referred to herein as the Secretary) has general superintendence of the assessment and collection of all duties and taxes imposed by any law providing internal revenue.[6] The states and territories are divided into some sixty-four collection districts,[7] each under the charge of a collector of internal revenue, with one or more deputy collectors. Returns of net income are filed with the local collector and the tax is paid to him, although the assessments are made by the Commissioner at Washington. The Commissioner, through his revenue agents or inspectors has supervisory power over, and authority to investigate, all accounts, lists or

6 U. S. Rev. Stats., § 321.

7 As a rule the boundaries of collection districts coincide with the boundaries of the states, but sometimes one collection district embraces two or three states, or one state is divided into two or more collection districts. Districts within a state are designated by number, as the first and sixth districts of California, being the two districts of that state. The lack of sequence in numbering is due to the consolidation of districts from time to time since the period immediately following the Civil War, when the country was divided into the maximum number of districts.

returns required to be made by persons liable to tax,[8] may examine the books of such taxpayers, and on refusal to allow an examination, may summon such person or corporation to produce the books and to appear before them to give testimony or answer interrogatories under oath respecting the matter.[9] Collectors and the Commissioner may make returns for taxpayers from their own knowledge and from such information as they can obtain through testimony or otherwise in cases where the taxpayer fails to file a return or makes a false or fraudulent return.[10] Appeals from decisions of Collectors may be taken to the Commissioner.[11]

REVENUE AGENTS AND INSPECTORS. The duties of officers of this class are to ascertain and report the names of persons who in their opinion are liable to the income tax and who have failed to make the returns required by law; to inquire into income tax returns where there is any suspicion that the return made is erroneous; to examine the books and accounts of persons who have made returns, for the purpose of ascertaining the reporting as to whether or not the law has been complied with, when so ordered by the agent in charge of the division to which they are assigned, who in turn reports to the Commissioner, and to the collector of the proper district. In the discharge of their official duties officers of this class are expected to exercise sound discretion, treat all persons with due courtesy, and, while acting firmly and courageously, to avoid all contention or controversy that would give just ground for complaint.[12]

Advisory Tax Board. Because of the large number of difficult cases arising under the Internal Revenue laws by reason of their great scope and the amount of revenue in-

8 Rev. Act of 1918, § 1305. See also U. S. v. Hodson, 14 Int. Rev. Rec. 100; 10 Wall 395, 406.

9 U. S. Rev. Stats., § 3173, as amended by Rev. Act of 1918.

10 U. S. Rev. Stats., § 3176, as amended by Rev. Act of 1918.

11 See Chap. 38, infra.

12 T. D. 1932.

volved in their collection, and to assure fair and adequate consideration of every case arising under such laws, an "Advisory Tax Board" has been created by the 1918 Law. The Commissioner may, and on the request of any taxpayer directly interested shall, submit to this Board any question relating to the interpretation or administration of the Internal Revenue laws and the Board reports its findings and recommendations to the Commissioner. The Board shall consist of not more than six members appointed by the Commissioner with the approval of the Secretary, and is to remain in existence until February 24, 1921, unless abolished before that time by the Commissioner with the approval of the Secretary. The Board has the power to summon witnesses, take testimony, administer oaths, and require any person to produce books, papers, documents, or other data relating to any matter under investigation. Any member may sign subpoenas, and members and employees of the Bureau of Internal Revenue designated to assist the Board, when authorized, may administer oaths, examine witnesses, take testimony, and receive evidence.[13]

Rulings and Regulations. The Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, is expressly authorized to make all needful rules and regulations for the enforcement of the provisions of the law.[14] Such rules and regulations are published under the caption of "Treasury Decisions" and are numbered serially for the purpose of reference.[15] At intervals large compilations of rulings and regulations are published by the Bureau of Internal Revenue and these are designated as "Regulations" and given a serial number.[16] As a gen-

[13] Rev. Act of 1918, § 1301.

[14] Id. § 1309.

[15] Treasury decisions contain rulings on all subjects over which the Bureau of Internal Revenue has jurisdiction. Those relating to the income tax are therefore not numbered in sequence. Reference to treasury decisions is usually made by abbreviation, thus "T. D. 2476."

[16] The last general compilation of rulings on the income tax is known as Regulations No. 45 Revised, issued February, 1919. All

eral rule, it may be said that these regulations have the force and effect of law and are as binding as if incorporated in the statute.[17] But they must be in execution of or supplementary to, and not in conflict with the provisions of the statute pursuant to which they are issued.[18] It is also held that they must be reasonable and a regulation defeating the purpose or enlarging the scope of the statute is invalid.[19] In determining whether a regulation is consistent with law the courts apply the same rule of decision which controls when an act of Congress is assailed as not being within the powers conferred upon it by the constitution, and it will not be held invalid unless it is plainly and palpably inconsistent with law and entirely inappropriate to the end specified in the Act of Congress.[20] The promulgation of a regulation does not estop the Treasury Department from reassessing the tax on a different basis if the courts hold that the regulation was not authorized by the law.[21] Regulations are admissible when pertinent to the issues, and as the courts take judicial notice of them as public records, it is unnecessary to introduce them formally in evidence.[22] What has been said of regulations applies only to the express terms of the regulation itself regularly promulgated and not to printed headings on a form additional to the express terms.[23] In ad-

previous rulings and decisions or parts thereof, including Regulations No. 33 issued January 5, 1914, and Regulations No. 33, Revised, issued February 4, 1918, which are in conflict with those contained in this revised compilation are thereby superseded and revoked, but any former rulings, not inconsistent, remain in effect.

17 Ex parte Kollock, 165 U. S. 526; U. S. v. Eaton, 144 U. S. 677; Stegall v. Thurman, 175 Fed. 813.

18 Edwards v. Keith, 231 Fed. 110.

19 Campbell v. U. S., 107 U. S. 410; U. S. v. Two Hundred Barrels of Whiskey, 95 U. S. 571; Morrill v. Jones, 106 U. S. 467; U. S. v. Three Barrels, 77 Fed. 963.

20 Boske v. Comingore, 177 U. S. 459.

21 Goldfield Consolidated Mines Co. v. Scott, 247 U. S. 126.

22 Sprinkle v. U. S., 141 Fed. 811; Caha v. U. S., 152 U. S. 211; Dominici v. U. S., 72 Fed. 46; Wilkins v. U. S., 96 Fed. 837.

23 U. S. v. Lamson, 162 Fed. 165.

dition to the rulings and regulations the Department issues so-called mimeograph letters to collectors, more or less confidential in their character and not intended for general publication. Frequently such letters throw light on the administration of the law and such mimeograph letters as have been made public are referred to in this book. Mimeograph letters are addressed to collectors only and not also "to others concerned" as are the official treasury decisions, and do not affect or give notice to taxpayers. Similarly, instructions to a particular collector do not affect collectors as a class.[24]

Retroactive Effect of Rulings. Treasury Department decisions promulgating rulings of the Internal Revenue Bureau become effective upon the date of approval unless otherwise stated therein. Cases previously adjusted in contravention of law as pronounced in such decisions, are subject to readjustment in accordance with the decisions.[25] Generally speaking any ruling or regulation made by the Treasury Department supersedes all prior rulings and regulations and is retroactive to the time the law was enacted, since a ruling or regulation is merely an interpretation of the meaning of the law, and in theory the meaning has been the same from the beginning. The Treasury Department recognizes, however, that in some instances it would be unjust or impracticable to reopen returns, adjustments or assessments which have been made in accordance with previous rulings, and where such rulings are superseded, an express limitation is made in the superseding ruling or regulation as to the retroactive effect thereof.[26]

United States. The term "United States" where used in a geographical sense in the law includes only the States,

24 Landram v. U. S., 16 Ct. Cls. 74.

25 Reg. 33 Rev., Art. 38.

26 See last paragraph of mimeograph letter to collectors dated August 14, 1914; I. T. S. 1918, ¶¶ 392 and 1344; also the last paragraph of T. D. 2313 and T. D. 2317.

the Territories of Alaska and Hawaii, and the District of Columbia.[27]

Possessions of the United States. The Revenue Act of 1918 does not extend to possessions of the United States. An individual who is a citizen of any possession of the United States, and who is not a resident of the United States, is taxable only on income derived from sources in the United States. In such cases the tax is computed and paid in the same manner and subject to the same conditions as in the case of non-resident alien.[28]

Porto Rico and the Philippines. The Revenue Act of 1918 does not apply to these possessions and the citizens thereof, who are not residents of the United States, are taxable only on income derived from sources within the United States. A local income tax, however, is provided for these possessions by making the Revenue Act of 1916, as amended, apply to them. Returns are required to be made and taxes to be paid to these respective possessions, under Title I of the Revenue Act of 1916, by (1) every individual who is a citizen or resident thereof or derives income from sources therein and (2) every corporation created or organized therein or deriving income from sources therein. An individual who is neither a citizen or resident of Porto Rico or the Philippines, but derives income from sources therein is taxed as a non-resident alien, and a corporation created or organized outside Porto Rico or the Philippines and deriving income from sources therein is taxed as a foreign corporation.[29] Under the present law, therefore, a citizen or resident of the United States, and a domestic corporation in the United States, is primarily liable to pay a tax in Porto Rico or the Philippines on income derived therefrom and also to the United States on the same income, but is entitled to deduct the amount of income tax paid to those possessions from the amount

27 Rev. Act of 1918, § 1.
28 Id. § 260.
29 Id. § 261.

due on the entire net income to the United States.[30] Under the 1916 Law these Possessions were treated as a part of the United States and only one tax was imposed on the income of taxpayers residing therein and deriving income from the states and territories, or vice versa.[31] Under the 1916 Law and also under the present law the Porto Rican or Philippine Legislature has power by due enactment to amend, alter, modify or repeal the income tax laws in force in its jurisdiction.[32]

Gross Income. Gross income is defined in the law to include income, gains or profits of all kinds except those enumerated as exempt from taxation. A more complete statement will be found in a subsequent chapter.[33]

Net Income. Net income is defined as gross income less the deductions allowed by the law, as is more fully stated in a subsequent chapter.[34] The law for the first time requires net income to be computed on the basis of the taxpayer's annual accounting period (fiscal year or calendar year as the case may be) in accordance with the method of accounting employed in keeping the books of such taxpayer. If no method of accounting has been employed or if the method employed does not clearly reflect the income, the computation is to be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.[35]

Deductions and Credits. The law specifies that certain deductions may be made from gross income in ascertaining the net income of the taxpayer. "Deductions" reduce the income for all purposes. "Credits" do not reduce the net income for all purposes, but reduce the net income of an individual for the purpose of the normal tax and not

30 Id. § 238.

31 Letter from Treasury Department dated April 4, 1917.

32 Rev. Act of 1918, § 260. See also Rev. Act of 1917, § 5. Since this power exists, it is not safe to assume that the income tax laws in those possessions are identical with the Rev. Act of 1916.

33 See Chapter 16.

34 See Chapter 16.

35 Rev. Act of 1918, § 212.

for the surtax, or, in the case of a corporation, reduce the net income for the purpose of the income tax and not for the purpose of the war-profits and excess-profits tax. Another form of credits provided by the law may be applied directly against the amount of tax and not the net income. These distinctions are more fully stated and explained in subsequent chapters.

Reporting Net Income. Taxpayers are required to file annually a return showing the amount of gross income received, the deductions, credits and exemptions claimed and the net income upon which the tax is to be imposed. This return is filed in the collection district in which the taxpayer resides or has his principal place of business. Non-residents having no place of business in this country file their returns with the Collector of Internal Revenue at Baltimore, Maryland.[36] The returns are required to be filed on or before March 15, if the report is made for the preceding calendar year. If made for a fiscal year, the returns are required to be filed on or before the 15th day of the third month following the close of the fiscal year. The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists.[37] In 1918 the time for filing returns for the year 1917 was extended generally for all taxpayers for a period of thirty days. The Commissioner of Internal Revenue has indicated an intention to make no general extension of time in 1919 for the filing of 1918 returns, but will permit extension on application of the taxpayer in all cases where good reason exists. Under the 1918 Law both individuals and corporations may file their returns for their fiscal years instead of for the calendar year if they are engaged in business and keep books of account which are regularly closed each year at the end of some month other than December. Individuals who keep books on the basis of a fiscal year are required to report the in-

[36] Id. § 227 and § 241. This district is the one in which Washington, the national capital, is located.

[37] Rev. Act of 1918, § 227 and § 241.

come for the fiscal year ending in 1918, and not for the calendar year, and to compute the tax on that basis. The tax so computed is proportioned according to the portion of the fiscal year falling within the year 1918.[38] One important change made by the 1918 Law is that partnerships will hereafter be required to file an annual return showing their net income although they are not subject to tax as partnerships.[39]

Record to Be Kept. Every individual, partnership or corporation liable to any tax imposed by the internal revenue laws of the United States, or for the collection thereof, is required to keep such records, to render such statements and returns under oath, and to comply with such regulations as shall be prescribed by the Commissioner of Internal Revenue. The Commissioner may also examine any books, papers, records or memoranda of a taxpayer.[40]

Individuals. Ordinarily, no person whose net income is less than $1,000 in any calendar year is required to file a return for that year, but the Commissioner may require any person, whether liable to tax or not, to file returns of income or such statements as he may deem sufficient to show whether or not such person is liable to tax.[41] Unmarried persons and married persons not living with husband or wife and receiving $1,000 or more net income during the calendar year, and married persons living with husband or wife and receiving $2,000 or more gross income during the same period, are required to file the annual return. Minors are now required to file returns if they have received the minimum amount of income specified in the law. Heretofore, the returns were required only of persons of lawful age.[42]

38 Reg. 45, Arts. 441 and 1624; See Chapter 34 for further discussion regarding returns. See also p. 30.

39 Rev. Act of 1918, § 224, see Chapter 10.

40 Id. § 1305; Reg. 45, Art. 1711; Reg. 33 Rev., Art. 50.

41 Id. § 1305.

42 See Chapter 4 for further discussion of this subject as to citizens and residents, and Chapter 5 as to non-resident aliens.

PERSONAL EXEMPTION. The personal exemption or credit is an arbitrary amount of net income on which residents and citizens (in some cases non-resident aliens) are not taxed.[43] It may be said to be an amount allowed for personal or family expenses, the actual amount of such expenses not being deductible in ascertaining the net income. The amount of the personal exemption allowed to an individual depends upon his status. Married persons living together and heads of families whether married or not are entitled to an exemption of $2,000. Others are entitled to $1,000. An additional exemption of $200 is allowed to any taxpayer whether single or married or head of family for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer, if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective.[44] A non-resident alien is entitled to claim these exemptions to the same extent as a citizen or resident unless he is a citizen or subject of a country which imposes an income tax and does not allow a similar exemption or credit to citizens of the United States not residing in such country. The personal exemption may be deducted only in computing the normal tax.[45] Heretofore corporations have not been allowed an exemption similar to the personal exemption allowed to individuals, but the 1918 Law provides that all corporations shall be entitled to an exemption of $2,000.

Normal Tax. The normal tax is a tax imposed upon all the net income of an individual in excess of (a) dividends received from taxable corporations; (b) the amount received as interest upon bonds and other obligations of

[43] Rev. Act of 1918, § 216 and § 217.

[44] Rev. Act of 1918, § 216. The exemption of $200 was formerly limited to cases of *children* dependent upon the taxpayer, and is now extended to cases where other persons are dependent as stated in the text.

[45] For a further discussion of the personal exemption, see Chapter 4 and Chapter 5.

the United States issued after September 1, 1917; (c) bonds issued by the War Finance Corporation; (d) the personal exemption and (e) the exemption for dependent persons.[46] For the year 1918 the rate of normal tax in the case of citizens and residents of the United States is 6% on the first $4,000 of income subject to normal tax and 12% on the remainder. Non-resident aliens are subject to a normal tax at the rate of 12% on all of the net income subject to normal tax received from all sources in the United States. For the year 1919 and subsequent years the rate applied in the case of citizens and residents of the United States will be 4% on the first $4,000 of income subject to normal tax and 8% on the remainder; and in the case of non-resident aliens 8% on all net income from sources within the United States subject to normal tax.[47]

Surtax. A surtax (sometimes called supertax or additional tax) is imposed upon the entire net income of individuals without deducting the personal exemption and including dividends and interest on United States obligations, issued after September 1, 1917, and bonds of the

[46] Rev. Act of 1918, § 216. The distinction made between incomes subject to normal tax and incomes subject to surtax is artificial and necessary only for the purpose of granting certain partial exemptions or taxing various kinds of income at different rates. The distinction between normal taxes and surtax seems to have originated in England where the income tax was first imposed at a proportional rate on all income and later graduated rates were applied to incomes over a minimum limit. One reason for distinguishing between normal taxes and surtaxes under our 1913 Law lay in the fact that the statute provided for withholding at the source of the normal tax, as does the English Law. Under the 1913 Law and the 1916 Law the normal tax was the rate which applied to corporations and individuals alike but under the present law this characteristic is destroyed since the normal tax is also a graduated tax. The law will no doubt always retain the distinction between normal and surtaxes since bonds of the United States are issued exempt from "normal tax," an exemption which, by the way is uncertain and precarious since it is within the power of Congress to reduce the normal tax at any time to a minimum and thereby practically destroy the tax exemption or raise the normal tax as is done by the present law in order to increase the exemption.

[47] Rev. Act of 1918, § 210.

War Finance Corporation. The surtaxes are a series of graduated rates the first of which is imposed on that part of the net income which exceeds $5,000 and does not exceed $6,000. Each additional $2,000 of net income is subject to a higher rate of tax than the preceding one up to and including $100,000 and thereafter the surtax is increased at less frequent intervals on income up to $1,000,000, the final rate being 65% on the amount by which the net income exceeds $1,000,000.[48]

Corporation Tax. For the year 1918 the income tax imposed on corporations will be at the rate of 12%, and for each calendar year thereafter at the rate of 10%. This rate might be said to measure the normal tax imposed on corporations in contradistinction to the graduated war-profits and excess-profits tax which is also imposed on corporations. For the purpose of the income tax the net income which is subject to the war-profits and excess-profits taxes is reduced by deducting therefrom certain credits consisting of (a) the amount received as interest on the bonds and obligations of the United States issued after September 1, 1917, and bonds issued by the War Finance Corporation; (b) the amount of any war-profits or excess-profits tax imposed on the net income for the same taxable year and (c) in the case of a domestic corporation the sum of $2,000.[49] Certain kinds of corporations not organized for profit, both domestic and foreign, are exempt from this tax.[50]

Personal-Service Corporations. The 1918 Law recognizes a new class of corporations being those whose income is due primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which the capital invested is not a material income producing factor. Such corporations are recognized as being

[48] Id. § 211. See Chapter 2 for schedule of rates of this tax.

[49] Id. § 230 and § 236. This subject is more fully stated in Chapter 12.

[50] See Chapter 15 for list of exempt corporations.

taxable in the same manner as partnerships. That is, the corporation is required to pay no tax but the stockholders are required to include in their personal returns their distributive shares of all the profits of such corporations whether distributed or not. Such corporations are those composed for instance of professional men or agents who have adopted the corporate form merely as an incidental convenience. The law expressly provides that no foreign corporation shall be considered to be a personal-service corporation, nor shall any corporation be so considered 50% of whose gross income consists either of gains, profits or income derived from trading as a principal or of gains, profits, commissions or other income derived from Government contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.[51]

Partnerships. A partnership itself is not taxable but the members of the partnership are required to report their distributive shares of the partnership income whether such income is actually distributed or not. The present law expressly states that where the fiscal year of a partnership ends within a calendar year the partner shall be taxed at the rates for the preceding calendar year on such proportion of his share of the partnership's net income equal to the proportion which the part of the fiscal year falling within such calendar year bears to the full fiscal year; and the rates for the calendar year during which such fiscal year ends shall apply to the remainder. For instance, if the partnership fiscal year ends June 30, 1918, the partner will be taxed at the 1917 rates on one half of his net income from the partnership and at the 1918 rates on the other half.[52] In making out his return for 1918 he will first report all his income to which the 1918 rates apply and then add to that amount the income to which the 1917 rates apply, taking the total for the purpose of determining the particular surtax rates of 1917 to be applied to that

[51] Rev. Act of 1918, § 200. For further discussion of this subject see Chapter 10 and as to excess-profits tax see Chapter 45.

[52] Rev. Act of 1918, § 205 and § 218.

part of the income which is taxable at the 1917 rates.[53] All partnerships will be required to file annual returns of income for the purpose of showing the amount of net income distributable to each partner.[54]

Collection of the Tax at the Source. Collection at the source, deduction at the source, withholding at the source and stoppage at the source, are synonymous terms meaning that the one paying income to another deducts or withholds an amount equal to the tax on the sum so paid and turns it over to the Government to the credit of the one against whom it was withheld. This method is used in order to facilitate the collection and to prevent evasion of the tax. Under the 1913 Law, and the 1916 Law during the year 1916, the tax was withheld on all payments of normal tax to individuals whether citizens, residents or non-resident aliens. Under the 1916 Law as amended by the 1917 Law the tax was not withheld on payments of income to citizens and residents (except in the case of bonds containing tax-free covenants).[55] Collection at the source applies at the present time only to (1) payments of fixed and determinable annual or periodical income to non-resident aliens in which case the tax is to be withheld at the rate of 8% (and if the Commissioner so rules the non-resident alien may claim exemption from withholding to the extent of his personal exemption); (2) payments of the same kind of income to non-resident foreign corporations not engaged in trade or business within the United States and not having an office or place of business therein, at the rate of 10% and (3) the Commissioner may authorize deduction at the source in the case of payments of any interest upon any securities the owners of which are not known to the withholding agent. The law is not clear whether the Commissioner may authorize deduction at the rate of 8% or 10% in the case of bonds not

53 Id. § 206.

54 Id. § 224.

55 Act of September 8, 1916, § 9(c) as amended by Act of October 3, 1917.

having "tax-free covenants" and it seems to be within his discretion; (4) in the case of payments of interest on bonds and similar obligations of domestic corporations which contain a so-called tax-free covenant the rate to be withheld in all cases is to be limited to 2% whether the owner be a citizen or resident or a non-resident alien or a foreign corporation or a domestic or foreign partnership. The only bondholders to which this provision does not apply are domestic and resident corporations. The Commissioner may authorize the tax of 2% to be withheld on interest on "tax-free covenant" bonds where the owner is not known.[56] It is to be noted that the only case in which withholding against citizens or residents of this country takes place is (4) above. In such cases the law is made to operate in order that the debtor corporation issuing such tax-free covenant bonds may be compelled to assume a part of the tax of the bondholder, since withholding does not actually take place.[57]

Information at the Source. For the purpose of checking up the returns of taxpayers the law provides for a system of information at the source, whereby every corporation may be required to report to the Commissioner of Internal Revenue the names and addresses of its stockholders and the amount of dividends paid to each;[58] stockbrokers may also be required, when called upon, to report the names and addresses of customers and information as to the profits and losses of each,[59] and all persons, corporations or partnerships may be required to report the names and addresses of any persons to whom they pay fixed or determinable gains, profits or income of $1,000 or more in any taxable year. In the case of payments of interest to the bondholders of corporations the names and addresses of such bondholders are required to be reported regardless of the amount paid during the year, as is also

56 Rev. Act of 1918, § 221 and § 237.
57 For further discussion of this subject see Chapter 40.
58 Rev. Act of 1918, § 254.
59 Id. § 255.

the rule in the case of collection of foreign items of interest and dividends.[60]

Payment of Tax. The income tax is due and payable in four installments, each consisting of one-fourth of the total tax. The first installment is payable at the time when the return is due to be filed, unless an extension of time for filing the return is granted in which case the first installment is due at the expiration of such extended period with interest at the rate of one half of one per cent from the date on which the return was originally due to be filed. The return is required to be filed on the 15th day of March (or the 15th day of the third month following the close of the fiscal year) and the second, third and fourth installments are due on the 15th day of the sixth, ninth and twelfth months respectively after the close of the taxable year.[61] In the case of a taxpayer filing a return for the calendar year the first installment will be due on March 15, the second on June 15, the third on September 15 and the last on December 15. In the event of default in the payment of any installment the whole amount of tax still unpaid becomes due and payable upon notice and demand by the collector. The above provisions do not apply to taxes collected at the source. The tax may be paid in a single payment instead of in installments. It is then due or payable, when the return is filed either at the date set by law or to which time to file the return has been extended.[62] No discount is allowed where such an advance payment is made. Receipts are no longer given for taxes paid, except upon the request of the taxpayer.[63]

Abatement and Refund. The collection of the income tax cannot be restrained by injunction, but if taxes have been erroneously or illegally collected, the Commissioner of Internal Revenue is authorized to remit and pay back the amount to the taxpayer. The importance of collecting

60 Revenue Act of 1918, § 256.
61 Id. § 250.
62 Id. § 250 (a).
63 Id. § 251.

revenue is so great that the law permits no taxpayer to interpose a hindrance to the orderly assessment of the tax. He must allow the tax to be collected and may thereafter claim abatement or refund.[64]

64 See Chapter 38 for procedure as to abatement and refund.

CHAPTER 2

THE INCOME TAX RATES

As indicated in the foregoing chapter, the income tax is now assessed and collected under one law, instead of two, as was the case in 1917.[1] The tax is imposed at two progressive rates (called the normal tax) on a part of the net income, and at a series of progressive rates on all the net income over $5,000 (called the surtax). In the case of corporations no surtax is imposed, the income tax rate being uniform on all amounts of net income.

Normal Tax. Under the Revenue Act of 1918 a normal tax of 6% is imposed upon the first $4,000 of taxable net income of citizens and residents for the calendar year 1918, and a normal tax of 12% upon the remainder of such taxable net income.[2] For each calendar year after 1918, these rates are 4% and 8% respectively.[3] In the case of non-resident alien individuals the rates are 12% on the taxable net income[4] for the calendar year 1918 and 8% upon such taxable net income for each calendar year thereafter. In assessing the normal tax of citizens

1 In 1917 the income tax was assessed and collected under two laws (Revenue Act of 1916 and Revenue Act of 1917).

2 Revenue Act of 1918, § 210 (a); Reg. 45, Art. 2. The subject of income is treated fully in Chapter 16 et seq.

3 Revenue Act of 1918, § 210 (b); Reg. 45, Art. 2.

4 In the case of non-resident alien individuals only income from sources within the United States, including interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise, and including dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture of goods within the United States, is taxable (Revenue Act of 1918, § 213 (c)).

or residents the following items are deducted from net income to determine taxable net income: (a) the amount received as dividends from a corporation which is taxable for income tax purposes on its net income, and amounts received as dividends from a personal-service corporation out of earnings or profits subject to income tax; (b) the amount received as interest upon obligations of the United States issued after September 1, 1917, and bonds issued by the War Finance Corporation, which is included in gross income; (c) the personal exemption.[5] In assessing the normal tax of non-resident alien individuals, the above items are deducted only on the condition that he files a return of his total income received from all sources, corporate or otherwise, in the United States including therein all information which the Commissioner may deem necessary for the calculation of his credits and deductions[6]; and in the case of non-resident alien individuals who are citizens or subjects of a foreign country imposing an income tax, the personal exemption is allowed only if such country allows a similar credit to citizens of the United States not residing in such country.[7] On all the net income in excess of the above items and the personal exemption, the normal rate applies.[8]

Comparative Statement of Normal Tax Rates. The rates of normal tax under the various laws since March 1, 1913, are as follows:

1913—1%; 1916—2%; 1917—2%; 1918—6% and 12% for the year 1918 and 4% and 8% for subsequent years. The corporation tax for each of the years up to 1917 was the same as the normal tax. In 1917 the normal tax rates imposed by the 1916 and 1917 Laws were applied to incomes of citizens and residents, but only the 1916 rate to non-resident aliens, while the corporation tax was 6%.

5 Revenue Act of 1918, §§ 210 and 216; Reg. 45, Art. 2.
6 Revenue Act of 1918, § 217.
7 Revenue Act of 1918, § 216 (e).
8 Revenue Act of 1918, § 211 (a).

Surtax. In addition to the normal tax a surtax is imposed at various and graduated rates under the present law. For the purpose of assessing the surtax the items deductible from net income for normal tax purposes and the personal exemption are not deducted.[9]

LIMITATION IN CASE OF SALES OF MINES, OIL OR GAS WELLS. In the case of a *bona fide* sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer the surtax attributable to such sale cannot exceed 20% of the selling price.[10] Exploration work alone without discovery is not sufficient to bring a case within this provision. Shares of stock in a corporation owning mines, oil or gas wells do not constitute an interest in such property. To determine the application of this provision to a particular case, the taxpayer should first compute the surtax in the ordinary way upon his net income, including his net income from any such sale. The proportion of the surtax indicated by the ratio which the taxpayer's profit from the sale of the property bears to the sum of his total income plus the general deductions not chargeable against any particular item of gross income is the portion of the surtax attributable to such sale, and if it exceeds 20 per cent of the selling price of the property such portion of the surtax shall be reduced to that amount.[11]

COMPARATIVE STATEMENT OF SURTAX RATES. The rates of surtax under the various laws since March 1, 1913, are as follows:

9 Revenue Act of 1918, § 211 (a); Reg. 45, Art. 11. The surtax was called "the additional tax" in the 1916 Law and the 1917 Law.

10 Revenue Act of 1918, § 211 (b).

11 Reg. 45, Art. 13.

On the amount by which the total net income

Exceeds	But does not exceed	1918 Law	1917 Law	1916 Law	1913 Law
$ 5,000	$ 6,000	1%	1%	None	None
6,000	7,500	2%	1%	None	None
7,500	8,000	2%	2%	None	None
8,000	10,000	3%	2%	None	None
10,000	12,000	4%	3%	None	None
12,000	12,500	5%	3%	None	None
12,500	14,000	5%	4%	None	None
14,000	15,000	6%	4%	None	None
15,000	16,000	6%	5%	None	None
16,000	18,000	7%	5%	None	None
18,000	20,000	8%	5%	None	None
20,000	22,000	9%	7%	1%	1%
22,000	24,000	10%	7%	1%	1%
24,000	26,000	11%	7%	1%	1%
26,000	28,000	12%	7%	1%	1%
28,000	30,000	13%	7%	1%	1%
30,000	32,000	14%	7%	1%	1%
32,000	34,000	15%	7%	1%	1%
34,000	36,000	16%	7%	1%	1%
36,000	38,000	17%	7%	1%	1%
38,000	40,000	18%	7%	1%	1%
40,000	42,000	19%	10%	2%	1%
42,000	44,000	20%	10%	2%	1%
44,000	46,000	21%	10%	2%	1%
46,000	48,000	22%	10%	2%	1%
48,000	50,000	23%	10%	2%	1%
50,000	52,000	24%	10%	2%	2%
52,000	54,000	25%	10%	2%	2%
54,000	56,000	26%	10%	2%	2%
56,000	58,000	27%	10%	2%	2%
58,000	60,000	28%	10%	2%	2%
60,000	62,000	29%	14%	3%	2%
62,000	64,000	30%	14%	3%	2%
64,000	66,000	31%	14%	3%	2%
66,000	68,000	32%	14%	3%	2%

Exceeds	But does not exceed	1918 Law	1917 Law	1916 Law	1913 Law
$ 68,000	$ 70,000	33%	14%	3%	2%
70,000	72,000	34%	14%	3%	2%
72,000	74,000	35%	14%	3%	2%
74,000	75,000	36%	14%	3%	2%
75,000	76,000	36%	14%	3%	3%
76,000	78,000	37%	14%	3%	3%
78,000	80,000	38%	14%	3%	3%
80,000	82,000	39%	18%	4%	3%
82,000	84,000	40%	18%	4%	3%
84,000	86,000	41%	18%	4%	3%
86,000	88,000	42%	18%	4%	3%
88,000	90,000	43%	18%	4%	3%
90,000	92,000	44%	18%	4%	3%
92,000	94,000	45%	18%	4%	3%
94,000	96,000	46%	18%	4%	3%
96,000	98,000	47%	18%	4%	3%
98,000	100,000	48%	18%	4%	3%
100,000	150,000	52%	22%	5%	4%
150,000	200,000	56%	25%	6%	4%
200,000	250,000	60%	30%	7%	4%
250,000	300,000	60%	34%	8%	5%
300,000	500,000	63%	37%	9%	5%
500,000	750,000	64%	40%	10%	6%
750,000	1,000,000	64%	45%	10%	6%
1,000,000	1,500,000	65%	50%	11%	6%
1,500,000	2,000,000	65%	50%	12%	6%
2,000,000	....	65%	50%	13%	6%

The 1913 rates applied to 1913, 1914, and 1915; the 1916 rates to 1916; the 1916 and 1917 rates were both imposed in 1917, and the 1918 rates apply to 1918 and subsequent years.

SURTAX TABLES. The following table shows the surtax under the 1918 Law on net incomes of the specified amounts. In each instance the first figure of net income in the net income column is to be excluded and the second

figure included. The percentage given opposite applies to the excess of income over the first figure in the net income column, and the sum in the next column is the tax on the entire difference between the first figure and the second figure in the net income column. The final column gives the total surtax on a net income equal to the second figure in the net income column.

Net income	Per cent	Surtax	Total surtax
$ 5,000 to $ 6,000....	1	$ 10	$ 10
6,000 to 8,000....	2	40	50
8,000 to 10,000....	3	60	110
10,000 to 12,000....	4	80	190
12,000 to 14,000....	5	100	290
14,000 to 16,000....	6	120	410
16,000 to 18,000....	7	140	550
18,000 to 20,000....	8	160	710
20,000 to 22,000....	9	180	890
22,000 to 24,000....	10	200	1,090
24,000 to 26,000....	11	220	1,310
26,000 to 28,000....	12	240	1,550
28,000 to 30,000....	13	260	1,810
30,000 to 32,000....	14	280	2,090
32,000 to 34,000....	15	300	2,390
34,000 to 36,000....	16	320	2,710
36,000 to 38,000....	17	340	3,050
38,000 to 40,000....	18	360	3,410
40,000 to 42,000....	19	380	3,790
42,000 to 44,000....	20	400	4,190
44,000 to 46,000....	21	420	4,610
46,000 to 48,000....	22	440	5,050
48,000 to 50,000....	23	460	5,510
50,000 to 52,000....	24	480	5,990
52,000 to 54,000....	25	500	6,490
54,000 to 56,000....	26	520	7,010
56,000 to 58,000....	27	540	7,550
58,000 to 60,000....	28	560	8,110
60,000 to 62,000....	29	580	8,690

Net income			Per cent	Surtax	Total surtax
$ 62,000	to $	64,000....	30	$ 600	$ 9,290
64,000	to	66,000....	31	620	9,910
66,000	to	68,000....	32	640	10,550
68,000	to	70,000....	33	660	11,210
70,000	to	72,000....	34	680	11,890
72,000	to	74,000....	35	700	12,590
74,000	to	76,000....	36	720	13,310
76,000	to	78,000....	37	740	14,050
78,000	to	80,000....	38	760	14,810
80,000	to	82,000....	39	780	15,590
82,000	to	84,000....	40	800	16,390
84,000	to	86,000....	41	820	17,210
86,000	to	88,000....	42	840	18,050
88,000	to	90,000....	43	860	18,910
90,000	to	92,000....	44	880	19,790
92,000	to	94,000....	45	900	20,690
94,000	to	96,000....	46	920	21,610
96,000	to	98,000....	47	940	22,550
98,000	to	100,000....	48	960	23,510
100,000	to	150,000....	52	26,000	49,510
150,000	to	200,000....	56	28,000	77,510
200,000	to	300,000....	60	60,000	137,510
300,000	to	500,000....	63	126,000	263,510
500,000	to	1,000,000....	64	320,000	583,510
1,000,000	up	....	65		

The surtax for any amount of net income not shown in the above table is computed by adding to the total surtax for the largest amount shown which is less than the income, the surtax upon the excess over that amount at the rate indicated in the table. For example, if the amount of net income is $63,128, the surtax is the sum of $8,690 (the surtax upon $62,000 as shown by the table) plus 30 per cent of $1,128, or $338.40, making a total surtax of $9,028.40.[12]

Computing the Tax—Illustration. The tax on a married person with a net income of $15,000 for the year 1918,

12 Reg. 45, Art. 12.

assuming that none of such income consists of (a) dividends from a corporation taxable for income tax purposes on its net income, or a personal service corporation out of earnings or profits subject to income tax, or (b) interest upon obligations of the United States and bonds issued by the War Finance Corporation, is computed as follows:

Normal Tax	Rate	Amount of Tax
$15,000 minus $2,000 (personal exemption) equals $13,000		
First $4,000 at.........	6%	$ 240
Remaining 9,000 at.........	12%	1,080
Surtax		
On first $5,000.............	0%	0
On next 1,000............. ($5,000 to $6,000)	1%	10
On next 2,000............. ($6,000 to $8,000)	2%	40
On next 2,000............. ($8,000 to $10,000)	3%	60
On next 2,000............. ($10,000 to $12,000)	4%	80
On next 2,000............. ($12,000 to $14,000)	5%	100
On next 1,000............. ($14,000 to $15,000)	6%	60
	Total,	$1,670

The tax on an unmarried person would be increased by 12% on $1,000 or $120, since the personal exemption is $1,000 less, and the balance of taxable net income over $4,000 would be increased accordingly. In case a married person or the head of a family is entitled to further exemption because of persons dependent upon him, the normal tax will be reduced at the rate of $24 for each such dependent, that is, 12% on $200.[13]

Husband and Wife. Where a husband and wife make returns of their joint incomes neither the normal tax or

[13] Revenue Act of 1918, § 216 (d).

surtax is to be computed on the joint income of both, but on the separate income of each although the incomes of both may be reported on the same return.[14]

Surtax on Stockholders in Respect of Undistributed Profits of Corporations. The surtax is ordinarily assessed only upon the income actually received by the taxpayer. But if any corporation however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, the corporation is not subject to income tax, and the stockholders are taxable as stockholders of a personal-service corporation, except that the war excess-profits tax paid by the corporation will be deducted from the net income of the corporation before the computation of the proportionate share of each stockholder or member.[15] This provision applies only where the accumulation is permitted for the purpose of avoiding the surtax. Ordinarily, the stockholder of a corporation has no need to concern himself with this provision or to make any inquiry as to the undistributed income of the corporation.[16] The fact that a corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business is *prima facie* evidence of a purpose to escape the surtax. The collectors, however, have no authority to decide when the gains and profits of a corporation are accumulated beyond the reasonable needs of the business, and therefore taxable as indicated above. The Commissioner must first certify that in his opinion the accumulation is unreasonable.[17] In any case the Commissioner or a collector may require a corporation to furnish

14 Revenue Act of 1918, § 216 (c); Reg. 45, Art. 2; T. D. 2090; T. D. 2137.

15 Revenue Act of 1918, § 220. Compare this section with section 3 of the Revenue Act of 1916. The taxation of personal service corporations is discussed in Chapter 10.

16 See T. D. 2135.

17 Revenue Act of 1918, § 220.

a statement of its gains and profits and of the names, addresses, and shareholdings of the stockholders, and if upon the basis of such statement or other evidence the Commissioner certifies that in his opinion its accumulation of profits is unreasonable for the purposes of the business the corporation and its stockholders shall make their returns accordingly.[18] When he has so certified the stockholders are notified thereof and called upon to add the amount of their respective shares in the undistributed gains and profits. of the corporation for the year to their income from other sources and to pay the surtax accordingly. This provision is broader than the provision contained in Section 3 of the 1916 Law, which authorized the Commissioner to assess a tax on the shareholders with respect to the undistributed profits only in cases where such profits were allowed to accumulate with fraudulent intent to avoid the surtax.

Rates Applicable to Fiscal Years. An individual keeping books on a fiscal year basis in 1918 is required by the law and regulations to report on the basis of such fiscal year.[19] Thus, an individual whose accounting period ended June 30, 1918, and who has made a return for the calendar year 1917, should make a complete return in accordance with the 1918 Law for the twelve months ended June 30, 1918.[20] Such return should be made on or before March 15, 1919,[21] unless an extension of time is obtained. The tax is to be computed on the entire net income of the full fiscal year under the 1918 Law and such proportion of the tax so computed as the portion of the fiscal year falling within the calendar year 1918 is of the full fiscal year shall be taken as the tax due with respect to the period from January 1, 1918, to the end of the fiscal year.[22] For the

18 Reg. 45, Art. 351.

19 Revenue Act of 1918, § 212 (b) and § 205 (a); Reg. 45, Arts. 25, 441, 1624.

20 Reg. 45, Art. 25.

21 Id., Art. 441.

22 Id., Art. 1624.

fiscal year ending in 1919 the tax is first to be computed at the 1918 rates on the entire net income for the fiscal year and second at the 1919 rates on the same income. The tax for the fiscal year will be a proportion of each of the amounts so determined as the portions of the fiscal year falling within the calendar year 1918 and within the calendar year 1919 are respectively to the full fiscal year.[23] The rules applicable to partnerships, personal-service corporations and corporations generally are treated elsewhere.[24]

[23] Id., Art. 1625.

[24] Chapter 10 contains the rules applying to partnerships and personal-service corporations; Chapter 12, corporations.

CHAPTER 3

INDIVIDUALS TO WHOM THE LAW IS APPLICABLE

The theory upon which the income tax is imposed seems to be two-fold. The law imposes the tax upon the net income of all persons within its jurisdiction, regardless of the source of such income, and upon all income arising from all sources within the United States, regardless of whether or not the United States has jurisdiction of the recipient. The tax has been defined as a tax on the person, measured by his ability to pay, that is, his net income,[1] and as a tax on the income itself.[2] As a matter of fact, it is both. The Government claims personal jurisdiction over all of its citizens wherever they reside and over all aliens who reside within its borders. Hence, as to citizens and resident aliens, the tax is imposed on income from all sources whether arising in this country or in a foreign country. No jurisdiction can be claimed over the persons of nonresident aliens, but insofar as their income is received from sources within this country, it is taxed on the theory that the Government has jurisdiction over the income, grants protection to the creation of such income, and is, therefore, entitled to a share thereof to defray the expenses of government.[3] The fact that a person is taxable in foreign

1 In Brady v. Anderson, 240 Fed. 665, writ of certiorari denied, 244 U. S. 564, the court said: "In our opinion the tax is against the citizens and residents of the United States personally. They are chargeable in respect to income received by them."

2 In a case decided by the Supreme Judicial Court of Massachusetts, Suter v. Jordan-Marsh Company, 113 N. E. 580, it was held that the tax was levied upon the rent paid by the defendant to the plaintiff. See also Catawessa R. R. v. Phila. & Reading Co., 255 Pa. St. 269.

3 Reg. 45, Art. 3.

countries on all or part of his income does not relieve him from tax liability on the same income in this country,[4] although he is entitled under the Revenue Act of 1918 to a credit in certain cases against his tax liability in this country by reason of the payment of taxes to foreign countries.[5]

Persons Exempt from the Tax. Individuals may enjoy exemption from the tax by reason of the amount or character of their income.

EXEMPTION BASED ON AMOUNT OF INCOME. Citizens and residents receiving less than $1,000 of net income during the year, if single, or less than $2,000, if the head of a family or a married person living with husband or wife, are exempt from the tax. Such persons are not required to file returns of annual income, but on demand of the Commissioner a statement sufficient to satisfy him that they are not liable.[6] Non-resident aliens are allowed the same personal exemptions on income received from sources within the United States of $1,000 and $2,000 if they file the required returns,[7] and provided the country of which they are citizens or subjects, if it imposes an income tax, allows similar credits to citizens of the United States not residing in such foreign country.[8] Citizens of possessions of the United States (but not otherwise citizens of the United States), who are not residents of the United States, are subject to taxation by the United States under the Revenue Act of 1918 only as to income derived from sources within this country.[9]

EXEMPTION BASED ON CHARACTER OF INCOME. Individuals may also enjoy an exemption from the tax because of the character of their income, since the law expressly pro-

4 T. D. 2152.

5 Revenue Act of 1918, §§ 222, 238. This credit against a person's tax should not be confused with the deduction of taxes in order to determine net income.

6 Revenue Act of 1918, §§ 223, 1305.

7 Reg. 45, Art. 315.

8 Revenue Act of 1918, §§ 216 (e), 217.

9 Revenue Act of 1918, § 260.

vides that certain kinds of income shall not be included in gross income and are exempt from the tax. Among the items of income so exempt [10] are: (a) the proceeds of life insurance policies paid upon the death of the insured, to individual beneficiaries, or to the estate of the insured, (b) the amount received by the insured as return of premiums paid by him under life insurance, endowment or annuity contracts, (c) property acquired by gift, bequest, devise or descent (but the income from such property is taxable), (d) amounts received through accident or health insurance or under Workmen's Compensation Acts as compensation for personal injuries or sickness and the amount of any damages received whether by suit or agreement, on account of such injuries or sickness, (e) so much of the amount received during the war with Germany by a person in the military or naval forces, as salary or compensation in any form from the United States, for active services in such forces, as does not exceed $3,500.[11] Income derived from the operation of a public utility acquired, constructed, operated or maintained under a contract made with a State, Territory, District of Columbia, or any political subdivision of the State or Territory, prior to September 8, 1916, is not taxed to the extent that the tax will impose a loss or burden on such State, Territory, District or political subdivision. Interest upon (1) the obligations of a State, Territory or any political subdivision thereof, the District of Columbia, or any possession of the United States, (2) securities issued under the provisions of the Federal Farm Loan Act, (3) the obligations of the United States, issued prior to September 1, 1917, is exempt. But every person owning any such obligations, securities or bonds, is required to submit a statement in his return, showing the

10 Revenue Act of 1918, § 213.

11 The term "active services" is probably used in the sense of services in all military and naval branches at home or abroad, as contradistinguished from the retired list. The term "military or naval forces" includes the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, and the Navy Nurse Corps, Female.

number and amount of such obligations, securities or bonds, and the interest received therefrom in such form and with such information as the Commissioner may require. In the case of obligations of the United States issued after September 1, 1917, and in the case of bonds issued by the War Finance Corporation, the interest is exempt only if and to the extent provided in the Acts authorizing the issue thereof, as amended and supplemented, and will be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer both under the income and war-profits and excess-profits taxes.[12] The 1916 Law expressly exempted the compensation of the present President of the United States, during the term for which he has been elected, and the compensation of the Judges of the Supreme Court and inferior courts of the United States, in office at the time the Act was passed, but the Revenue Act of 1918 expressly taxes the compensation received as such of the President of the United States, the Judges of the Supreme Court and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia.[13] The Revenue Act of 1918 does not expressly exempt "the compensation of all officers and employees of a State, or any political subdivision thereof, except when such compensation is paid by the United States Government," [14] as did the 1916 Law. Officers and employees of a State, City or County, including public school teachers, etc., were exempt under the 1916 Law to the extent that their income was derived from salaries paid by the State, County or City. They enjoyed, however, no exemption from tax on income from taxable sources merely because of their position as employees of a

[12] Revenue Act of 1918, §§ 213 (b) 4, 233.

[13] Revenue Act of 1918, § 213 (a). The constitutional question involved in taxing such salaries is discussed in Chapter 17 on Income from Personal Services.

[14] Revenue Act of 1916, § 4.

State. It seems to have been the intent of Congress in the present statute to tax such salaries and to leave the constitutional question involved in levying such a tax to the courts,[15] but the Treasury Department has ruled that compensation paid to its officers and employees by a state or any political subdivision thereof, will not be taxed.[16] Exempt income is omitted from the returns of individuals and corporations,[17] but income exempt for only normal and not surtax, or for income but not profits tax, must be included in the return.

Citizens of the United States. Every person born in the United States subject to its jurisdiction, or naturalized in the United States, is a citizen. An individual born in the United States of citizen or resident alien parents, who has long since moved to a foreign country and established a domicile there, but who never has been naturalized therein or taken an oath of allegiance thereto is still a citizen of the United States.[18] Citizens are taxable upon their net incomes from all sources whether they reside within this country or not. Married women are considered to have the same citizenship as their husbands. An American woman who marries a foreigner consequently loses her status as an American citizen and is thereafter treated as an alien.[19] But determination by the State Department of the status of an individual is not conclusive upon the Treasury Department in fixing citizenship for income tax purposes.[20]

15 Revenue Act of 1918, § 213 (a). The constitutional question involved in taxing such salaries is discussed in Chapter 17 on Income from Personal Services.

16 Reg. 45, Art. 71. This subject is more fully discussed in Chapter 17 on Income from Personal Services.

17 Exempt interest, however, is included as above indicated. Under the 1916 Law corporations were at first required to report exempt income in a supplementary statement, but this requirement was omitted in later forms.

18 Reg. 45, Art. 4.

19 T. D. 2092.

20 T. D. 2135.

Residing in the United States. Citizens residing in the United States report and pay the tax in the district in which they legally reside or have their principal place of business, regardless of where the income may arise.[21]

Residing Abroad. If a citizen residing abroad has no office or place of business in this country, he files his return and pays his tax to the Collector at Baltimore, Maryland.[22] He is, of course, required to report his income from all sources whether within or without the United States. Although the question as to the liability of a nonresident citizen is not determined by the State Department but by the Treasury Department, still, in the case of a naturalized citizen against whom the presumption of expatriation has arisen, the fact that he has paid the income tax will receive due consideration by the State Department in connection with other evidence submitted to overcome such presumption in connection with applications for passports or for registration in a consulate or for actual protection in a foreign country. The payment of the income tax will also be duly considered by the State Department in passing upon rights to the continued protection of this Government in cases of native American citizens who have resided abroad for a period so long that the natural presumption may be held to have arisen that they have abandoned citizenship in this country.[23]

Aliens Residing in the United States. The question of whether or not an alien resides in this country is sometimes difficult to determine. The Treasury Department holds that "Nonresident alien individual" means an individual (a) whose residence is not within the United States, and (b) who is not a citizen of the United States. Any alien living in the United States who is not a mere transient is a resident of the United States for purposes of the income tax. Whether he is a transient or not is

[21] Revenue Act of 1918, § 227 (b); Reg. 45, Art. 445.

[22] Revenue Act of 1918, § 227 (b).

[23] Letter from Secretary of State to American Diplomatic and Consular Officers, dated March 18, 1914; I. T. S. 1918, ¶ 5.

determined by his intentions with regard to his stay. The best evidence of such intentions is afforded by the conduct, acts, and declarations of the alien. The typical transient is one who stops for a short time in the course of a journey through the United States, sometimes performing labor, sometimes not, or one who enters the United States intending only to stop long enough to carry out some purpose, object, or plan not involving an extended stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. An alien's statements as to his intention with regard to residence are not conclusive, but when unequivocal will determine the question of his intention, unless his conduct, acts, or other surrounding circumstances contradict the statements. It sometimes occurs that an alien who genuinely intends his stay to be transient may put off his departure from time to time by reason of changed conditions, remaining a transient though living in the United States for a considerable time. The fact that an alien's family is abroad does not necessarily indicate that he is a transient rather than a resident. An alien who enters this country intending to make his home in a foreign country as soon as he has accumulated a sum of money sufficient to provide for his journey abroad is to be considered a transient, provided his expectation in this regard may reasonably, considering the rate of his saving, be fulfilled within a comparatively short time. It will be presumed that an alien who has established a residence in the United States, as outlined above, continues to be a resident until he or his family evidence an intention to change their residence to another country by starting to remove. Thus, alien residents who, following the armistice agreement of November, 1918, take steps toward returning to their native countries, as by applying for passports, are to be regarded as residents for that portion of the taxable year which elapsed up to the time such step was taken.[24] The Treas-

[24] Reg. 45, Arts. 311, 312, 313. This rule differs from the English

ury Department has adopted the following definition of the word "residence" as used in the income tax laws: "That place where a man has his true, fixed and permanent home and principal establishment, and to which, whenever he is absent, he has the intention of returning; and indicates permanency of occupation as distinct from lodging or boarding, or temporary occupation."[25] Aliens coming into the United States with the intention of becoming residents and other resident aliens can establish the fact of their residence and acquire the privileges of resident aliens under the statute, by filing a certificate with the withholding agents charged with the duty of withholding the tax on income paid to non-resident aliens.[26]

Non-Resident Aliens. Non-resident aliens are those individuals who are neither citizens nor residents of this country.[27] As stated above, they are taxable only to the extent of the income they receive from sources within the United States, including interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States.[28] If a non-resident alien conducts business through an agent in this country, the agent will be subject to the duty of filing a return for his non-resident

rule which provides that a person within the United Kingdom, for some temporary purpose only for less than six months during the year, is not taxable as a resident, but after a residence of six months he becomes chargeable with the duties for the year commencing on April 6th preceding.

25 T. D. 2242.

26 Reg. 45, Art. 362; T. D. 2242. This certificate is known officially as Form No. 1078 (Revised).

27 Reg. 45, Art. 311. Citizens of Porto Rico or the Philippines, who are not residents of the United States, are treated as non-resident aliens as to income derived from sources within the United States. (Revenue Act of 1918, § 260.)

28 Revenue Act of 1918, § 213 (c).

principal and of paying both the normal tax and the surtax.[29]

Husband and Wife. In so far as possible the family is treated as a unit for purposes of the income tax, and the husband and wife may make joint returns.[30] Unless the wife files a separate return of income or joins with her husband in a return which shall set forth her income separately, her husband should include in his return the income accruing to the wife from services rendered by her or the sale of products of her labor.[31] The personal exemption is in such cases deducted from the joint income, but the normal tax and the surtax is in all cases imposed upon the separate incomes.[32]

Minors. Under the 1916 and 1917 Laws, minors were not required to make returns for themselves, their returns being required to be made by their guardians.[33] This rule is now changed, and minors are required to make returns unless their income is included in the return of the parent or reported by a fiduciary.[34]

Incompetents. Incompetents or insane persons are unable to make their own returns, and their returns are required to be made by the guardian or other person charged with the care of the person or property of such incompetent or insane person.[35]

Agents. The return may be made by an agent when by reason of illness, absence, or nonresidence the person

29 Revenue Act of 1918, § 223; Reg. 45, Art. 403.

30 Revenue Act of 1918, § 223.

31 Reg. 45, Art. 401.

32 Reg. 45, Art. 2; T. D. 2090.

33 Reg. 33, Art. 17; Letter from Treasury Department dated April 11, 1918; I. T. S. 1918, ¶ 3295.

34 Revenue Act of 1918, § 223; Reg. 45, Art. 402. This change was accomplished by the omission of the words "of lawful age" from the section requiring returns of individuals. Compare Revenue Act of 1916, § 8 (b) with Revenue Act of 1918, § 223. Obviously, minors not *sui juris* are still unable to make their own returns, and the returns of such minors will necessarily continue to be made by the guardian or other persons charged with the care of their persons or property.

35 Revenue Act of 1918, § 223; Reg. 45, Art. 422.

liable for the return is unable to make it, the agent assuming the responsibility for making the return and incurring liability to the specific penalties provided for erroneous, false, or fraudulent returns.[36] Responsible representatives of non-resident aliens having charge of the property of non-resident aliens may be charged with the duty of making a return and paying the tax on the income passing through their hands.[37]

Fiduciaries. Guardians, trustees, executors, administrators, receivers, conservators or any persons acting in a fiduciary capacity are charged with special duties under the law. These duties are fully discussed in another chapter.[38]

Persons Dying During the Year. When a person dies during any calendar year it is the duty of the executor or administrator or person taking charge of his property to make a return for the deceased from the beginning of the year to the date of death.[39] In this return should be reported all of the income received up to the time of death and all the allowable deductions and credits up to that time. The personal exemption may be claimed in full according to the status of the decedent and regardless of the length of time during the year in which he lived.[40] In case the decedent dies after the close of the calendar year, but before March 15th of the following year, and has not made a return for the preceding calendar year, a return should be made for the full year preceding and in addition a return from January 1 of the current year to the date of death. If during the period in which the decedent lived he was not in receipt of $1,000 of net income, if unmarried, or $2,000, if married or the head of the family, no return need be filed,[41] unless he was a non-resident

36 Revenue Act of 1918, § 223; Reg. 45, Art. 401.

37 Revenue Act of 1918, § 223; Reg. 45, Art. 403.

38 Revenue Act of 1918, § 225. See Chapter 8 on Fiduciaries.

39 Reg. 45, Art. 421. Mandell v. Pierce, 3 Cliff 134, 16 Fed. Cas. No. 9008.

40 T. D. 2090, T. D. 2135.

41 Reg. 45, Art. 421.

alien, in which case a return should be filed, whether married or single, regardless of amount.[42] The fact that a person may have died before the passage of the law does not relieve his estate from liability for tax, if he lived during any part of the time after the incidence of the tax. Thus a person dying after January 1, 1918, but before February 25, 1919, the date on which the 1918 Law went into effect, will be held to be taxable thereunder. The effect of making the act retroactive is to apply it to him exactly as if it had been enacted on January 1, 1918.[43]

[42] Reg. 33, Rev., Arts. 4 and 14; Reg. 45, Art. 403.

[43] Brady v. Anderson, 240 Fed. 665, writ of certiorari denied, 244 U. S. 654.

CHAPTER 4

CITIZENS AND RESIDENTS OF THE UNITED STATES

All citizens of this country, residing here and elsewhere, and all residents of this country, whether citizens or not, are classed together for the purpose of the income tax.[1] The scope of the terms "citizens" and "residents" is discussed in a previous chapter.[2] The taxable year is the time unit for the purpose of the tax.[3] The term is used in this chapter in the sense defined in the Revenue Act of 1918 and means the calendar year or the fiscal year ending during such calendar year upon the basis of which net income is computed. The first taxable year is called the taxable year 1918, and is the calendar year 1918 or any fiscal year ending therein.[4] The term "personal-service corporation" is used in this chapter as defined in the chapter on that subject and other terms are defined as used.

Extent to Which Taxable. Citizens and residents are taxable for the purpose of the surtax upon their entire net income received in each year from all sources and for the purpose of the normal tax upon net income less statutory credits.[5] Exempt income is not included in gross income, which is the foundation for the computation of net income.[6] On dividends of corporations taxable upon their net income and dividends of personal-

1 Reg. 45, Art. 3.
2 See Chapter 3 on Individuals to Whom the Law is Applicable.
3 Reg. 45, Art. 1533.
4 Revenue Act of 1918, § 200.
5 Reg. 45, Arts. 3 and 21.
6 Revenue Act of 1918, § 212; Reg. 45, Art. 21.

service corporations, out of earnings or profits upon which income tax has been imposed, they are liable only for surtaxes; and so also with respect to interest on bonds of the United States issued after September 1, 1917, and bonds of the War Finance Corporation. The regulations and rulings respecting taxable and non-taxable income are, as a rule, applicable both to individuals and corporations, and are discussed in detail in the later chapters on income.[7]

Deductions Allowed. Citizens and residents are allowed the following deductions in computing net income for the purpose of the tax. Many of the deductions are the same as those permitted to corporations and in such cases they are fully discussed in subsequent chapters.[8] In this chapter only the special provisions applicable to individuals are discussed at length.

Business Expenses. Citizens and residents may deduct from their gross income all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries, or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.[9]

BUILDINGS USED FOR RENTAL PURPOSES. A landlord may claim as an expense any amounts expended for maintenance of the property or its use for rental purposes, including amounts paid for repairs, insurance, fuel, light

[7] See Chapter 16 et seq.

[8] See Chapter 26 et seq.

[9] Revenue Act of 1918, § 214 (a); Reg. 45, Arts. 101-112. The Revenue Act of 1918 further qualifies the expenses deductible as stated in the text above by stipulating that they all be "ordinary" as well as "necessary," allows their deduction if "incurred" as well as "paid," omitting the adverb "actually" in connection with the word "paid."

and water, and janitor and elevator service, if any.[10] Where the landlord occupies a part of the building as his own dwelling he should not deduct such proportion of the expenses of operating the building as inure to his personal benefit, as that part constitutes personal or living expenses which are not deductible. Thus, if a landlord lives in one-half of the building, one-half of the expenses are not allowable deductions in his return.

Interest. A citizen or resident may with one exception deduct all interest paid or accrued within the taxable year on his indebtedness.[11] This includes not only indebtedness incurred for business purposes, but indebtedness incurred for any purpose, such as for the purpose of buying dwelling houses or any articles or things of personal use. The one limitation on the amount of interest which may be deducted is with respect to interest paid or accrued on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is wholly exempt from taxation as income to the taxpayer.[12]

Taxes. Citizens or residents may deduct taxes paid or accrued within the taxable year imposed (a) by the authority of the United States except income, war profits and excess-profits taxes, (b) by the authority of any state or territory, or any county, school district, municipality or other taxing subdivision of any state or territory, or (c) by the authority of any possessions of the United States or any foreign country, except the amount of income, war-profits and excess-profits taxes allowed as a credit against the tax.[13] Taxes assessed against local benefits of a kind tending to increase the value of the property

10 Letter from the Treasury Department dated February 26, 1915; I. T. S. 1918, ¶ 353.

11 Revenue Act of 1918, § 214 (a) 2.

12 Revenue Act of 1918, § 214 (a) 2; Reg. 45, Arts. 121 and 122. For a further discussion of this subject, see Chapter 28 on Deduction of Interest.

13 See Chapter 33 for statement of credit for taxes.

may not be deducted.[14] Inheritance taxes are not taxes contemplated by this provision, and may not be deducted.[15]

Losses. The 1918 Law makes a radical departure in the provisions allowing deduction of losses in the case of individuals in that losses sustained during the taxable year by citizens or residents and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck or other casualty or from theft. Other provisions of the 1918 Law provide that if a business has sustained a net loss in any year after October 31, 1918, and before January 1, 1920, such loss may be deducted from the net income of the preceding year and the tax readjusted accordingly. Another provision provides that if it is found during 1919 that the value of inventory has shrunk the loss consequent thereto may be deducted from the income of the taxable year 1918. Under the 1916 Law individuals were allowed to deduct in full all losses sustained in trade but only to a limited extent losses not sustained in trade. The various kinds of losses are discussed in the following paragraphs with reference to their deductibility under the present law and under preceding laws.

Losses Sustained in Trade. Under the present and preceding laws losses sustained during the taxable year and not compensated for by insurance or otherwise, may be deducted if incurred in trade or business.[16] A loss incurred in trade or business must be an absolute loss not

14 Revenue Act of 1918, § 214 (a) 3; Reg. 45, Arts. 131-134. For a full discussion of this subject, especially changes made by the present law, see Chapter 29 on Deduction of Taxes.

15 Reg. 45, Art. 134. Letter from Treasury Department dated February 10, 1916; I. T. S. 1918, ¶ 486. For a discussion of the deductibility of inheritance taxes, see Chapter 29 on Deduction of Taxes.

16 Revenue Act of 1918, § 214 (a) 4; Reg. 45, Art. 141. For a full discussion of this subject see Chapter 30 on Deduction of Losses.

a speculative or fluctuating valuation of a continuing investment, and must be determined and ascertained to be an actual, a completed, a closed transaction.[17]

TRADE OR BUSINESS. Under the 1916 Law, the term "trade" and the term "business" were defined as synonymous terms and to be, "That which occupies and engages the time, attention and labor of anyone for the purpose of livelihood, profit, or improvement; that which is his personal concern or interest; employment, regular occupation, but it is not necessary that it should be his sole occupation or employment." The doing of a single act incidentally or of necessity not pertaining to the particular business of the person doing the same will not be considered engaging in or carrying on business.[18] "In trade," as used in the 1916 Law, is held to mean the trade or trades in which the person making the return is engaged; that is, in which he has invested money, otherwise than for the purpose of being employed in isolated transactions, and to which he devotes at least a part of his time and attention. A person may be engaged in more than one trade and may deduct losses incurred in all of them under this provision of the law, provided that in each trade the above requirements are met. Losses on stocks, grain, cotton, etc., may also be deducted under this provision by a person engaged in the trade to which buying or selling thereof are incident as a part of the business, as by a member of a stock, grain or cotton exchange,[19] but neither the investment of money in the stock of a company nor employment by the company in any official capacity makes the business of the company the trade of the investor or employee.[20] The losses which

17 T. D. 1989. Depreciation in the value of property is treated as a separate deduction and should not be confused with loss.

18 T. D. 1989.

19 T. D. 2090.

20 T. D. 2135. The definition of "trade or business" discussed in the text above has now lost considerable importance in view of the provision (Revenue Act of 1918, § 214 (a) 5) that losses incurred in any transaction entered into for profit may be deducted even

were limited by this provision of the 1916 law were those incurred in transactions involving sales or dealings in property. The law seemed clearly to make a distinction between such losses and losses arising from fires, storms, shipwreck, or other casualty, and from theft.

Net Losses of Any Business. If for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, a citizen or resident has sustained a net loss as defined in the next paragraph, the same is allowed as a deduction in computing his net income for the *preceding* taxable year, and the income and the war profits and excess-profits taxes imposed by the Revenue Act of 1918 for such preceding taxable year may be redetermined accordingly. Any amount found to be due upon the basis of such redetermination to a citizen and resident is credited or refunded to him, and if such net loss for the preceding taxable year is in excess of his net income for the same year, the amount of such excess may be allowed as a deduction in computing his net income for the succeeding taxable year. Such net loss must be proved by evidence satisfactory to the Commissioner and the deduction thereof is subject to regulations to be prescribed by him with the approval of the Secretary.[21] This subject is more fully discussed in another chapter.[22]

though such losses exceed the profits arising from the same class of transactions. Under the 1916 Law, it will be noted, the Treasury Department adopted an extremely narrow construction of the words "business or trade," a construction which has been the subject of considerable criticism and which operated to the detriment of every person investing or speculating in property. Congress has now seen fit to remedy the injustice involved in this narrow construction by permitting the deduction of all losses in transactions entered into for profit even though they may exceed the profits arising from the same transactions (Revenue Act of 1918, § 214 (a) 5). Consequently the definitions of "trade or business" discussed in the text above are no longer so important except in cases arising under the 1916 and 1913 Laws.

21 Revenue Act of 1918, § 204 (b); Reg. 45, Arts. 1601-1603.

22 See Chapter 30 on Deduction of Losses.

DEFINITION OF NET LOSS. The term "net loss" as used in the foregoing paragraph refers to net losses resulting from (1) the operation of any business regularly carried on by the citizen or resident, or (2) the *bona fide* sale by him of a plant, buildings, machinery, equipment or other facilities constructed, installed or acquired by him on or after April 6, 1917, for the production of articles contributing to the prosecution of the war with Germany; and when so resulting from either of the above sources, the term "net loss" means the excess of the deductions allowed to the citizen or resident over the sum of his gross income and any interest received free from income and war excess-profits taxation.[23]

Losses Not Sustained in Trade. Under the present law citizens and residents may deduct all losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business.[24] Under the 1916 Law, a citizen was permitted to deduct the losses actually sustained in transactions entered into for profit but not connected with his business or trade only to an amount not exceeding the profits arising therefrom. A loss was required to be actually sustained during the year and the total amount deductible could not exceed the profits arising from the same class of transactions.[25] Thus, an individual making any investments in property from time to time or speculating was required to report all gains from such investments or speculations and might offset against the gains all losses sustained in similar transactions. He was required to report only the net gain from such transactions during the year, and if the net result for the year of a series of such transactions was a loss, he was not entitled to offset the loss against his income from trade or business.[26] It

[23] Revenue Act of 1918, § 204 (a); Reg. 45, Art. 1601.

[24] Revenue Act of 1918, § 214 (a) 5.

[25] Revenue Act of 1916, § 5.

[26] Prior to the 1916 Law it was held by the Treasury Department that an individual was required to report all income from transac-

will be noted that the present law makes an important departure from the 1916 Law and permits the deduction of all losses incurred in transactions entered into for profit though not connected with a trade or business, notwithstanding that such losses may exceed the profits arising from the same class of transactions.

Losses of Property from Fire, Storms, etc. Citizens and residents may deduct losses sustained during the taxable year of property whether or not connected with their trade or business if arising from fires, storms, shipwreck, or other casualties, or from theft, and if not compensated for by insurance or otherwise.[27] Under the 1916 Law the Treasury Department held that such losses should be of property employed in the business or trade of the individual and must be sustained in trade in order to be deductible, although the 1916 Law did not seem to support this ruling.[28]

Losses in Value of Inventory. The Revenue Act of 1918 contains a new remedial provision for permitting the deduction by individuals and corporations of losses sustained during the preceding taxable year and not deducted from the gross income therefor. It is provided that at the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such cases payment of the amount of the tax covered by such claim will not be required until the claim is decided, but the taxpayer must accompany his claim with a bond in dou-

tions not incurred in trade, but was not entitled to deduct any of the losses. (T. D. 2135.)

27 Revenue Act of 1918, § 214 (a) 6.

28 Revenue Act of 1916, § 5 (a). See T. D. 2015.

ble the amount of the tax covered by the claim, with sureties satisfactory to the Commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim is disallowed then the remainder of the tax due shall on notice and demand by the collector be paid by the taxpayer with interest at the rate of 1 per centum per month from the time the tax would have been due had no such claim been filed. If it is shown to the satisfaction of the Commissioner that such substantial loss has been sustained, then in computing the income tax the amount of such loss may be deducted from the net income. If no such claim is filed, but it is shown to the satisfaction of the Commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described, then the amount of such loss may be deducted from the net income for the taxable year 1918 and the income tax for such year will be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination will be credited or refunded to the taxpayer.[29] This subject is more fully discussed elsewhere.[30]

Worthless Debts. Citizens and residents may deduct all debts ascertained to be worthless and charged off within the taxable year. The law does not require such debts to have been incurred in the trade or business of the individual. It is sufficient if a debt is legally due and owing to the taxpayer and has actually been ascertained to be worthless, and has been charged off within the taxable year.[31]

Depreciation. Citizens and residents are permitted a reasonable allowance for the exhaustion, wear and tear of property used in their trade or business including a

[29] Revenue Act of 1918, § 214 (a) 12; Reg. 45, Art. 261.

[30] See Chapter 30 on Deduction of Losses.

[31] Revenue Act of 1918, § 214 (a) 7; Reg. 45, Art. 151-154. For a further discussion of this subject see Chapter 30 on Deduction of Losses.

reasonable allowance for obsolescence.[32] It is to be noted that this deduction applies expressly to property used in the individual's business or trade. No allowance for depreciation can be claimed upon other property, such as the individual's residence or his pleasure automobile. This limitation applies expressly to individuals. In other respects the provisions for allowing depreciation in the case of individuals and corporations are the same, and are treated in a subsequent chapter.[33]

Depletion of Natural Resources. Individual owners or lessees are permitted the same allowance in the case of the depletion of mines, oil and gas wells, other natural deposits, and timber, and for depreciation of improvements as is allowed to corporations. This subject is discussed in a subsequent chapter.[34]

Contributions to Charities. A citizen or resident is allowed to deduct from his net income contributions or gifts actually made within the taxable year to corporations or associations organized and operated exclusively for religious, charitable, scientific or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private stockholder or individual, or to the special fund for vocational rehabilitation authorized by the Vocational Rehabilitation Act. This deduction, however, is limited to an amount not in excess of 15% of the taxpayer's net income including the amount of such contributions. The law further provides that such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Treasury Department.[35] In connection with a claim for this deduction the following information is required to be stated on returns of income: (a) The name and address of each organization to which a gift was made. (b)

[32] Revenue Act of 1918, § 214 (a) 8.
[33] See Chapter 31 on Depreciation.
[34] Revenue Act of 1918, § 214 (a) 10. See Chapter 32.
[35] Revenue Act of 1918, § 214 (a) 11.

The date and amount of the gift in each case. Where the gift is other than money, the basis for calculation of the value of the gift shall be the fair market value of the property the subject of gift at the time of the gift. A gift of real estate to a city to be maintained perpetually as a public park is not allowable deduction.[36] Donations made by a partnership may be prorated among the individual partners for the purpose of their individual income tax returns.[37] This deduction is not allowed to corporations.[38]

Amortization. In the case of buildings, machinery, equipment or other facilities constructed, erected, installed or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the war with Germany, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the war with Germany, a reasonable deduction is allowed to citizens and residents for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer but not again including any amount allowed under the Revenue Act of 1918 or previous income tax laws as a deduction in computing net income. At any time within three years after termination of the war with Germany on the date fixed by proclamation of the President, the Commissioner may, and at the request of the taxpayer must, re-examine the return and if he then finds as a result of an appraisal or other evidence that the deduction originally allowed is incorrect, the income and war-profits and excess-profits taxes for the year or

36 Reg. 45, Art 251. See also Reg. 33 Rev., Art. 8.

37 Letter from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3437.

38 Thus, Red Cross contributions are not deductible by corporations (Telegram from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3436). Contributions are allowed to corporations, however, in some cases when they have consideration in some form so as to take them out of the class of gratuities. See Chapter 27 on Deduction of Business Expenses.

years affected must be re-determined and the amount of the tax due upon such re-determination, if any, must be paid by the taxpayer upon notice and demand by the collector. The amount of tax overpaid, if any, must be credited or refunded to the taxpayer.[39] This deduction is also allowed to corporations and is discussed more fully in a subsequent chapter.[40]

Items Not Deductible. Certain items are expressly declared not to be deductible in computing net income.

PERSONAL, LIVING OR FAMILY EXPENSES. In computing net income no deduction is allowed in respect of personal, living or family expenses.[41] These expenses may be said to be covered by the arbitrary sum allowed as a personal exemption. Insurance paid on a dwelling owned and occupied by a taxpayer is a personal expense. Premiums paid for life insurance by the insured are not deductible. In the case of a professional man who rents a property for residential purposes, but incidentally receives there clients, patients or callers in connection with his professional work (his place of business being elsewhere), no part of the rent is deductible as a business expense. The father is legally entitled to the services of his minor children, and allowances which he gives them, whether said to be in consideration of services or otherwise, are not allowable deductions in his return of income. Amounts paid out for expenses for meals and lodging and the like by salesmen, actors, and others traveling in the course of their employment are their living expenses and can not be deducted from gross income.[42] The rule however, would seem to be otherwise in the case of one who is temporarily away from home on business and incurs expense

[39] Revenue Act of 1918, § 214 (a) 9. See § 252 in regard to the crediting or refunding of taxes overpaid.

[40] See Chapter 31 on Depreciation.

[41] Revenue Act of 1918, § 215 (a).

[42] Reg. 45, Arts. 291 and 292. The same rule was followed under the Civil war income tax laws. 7 Int. Rev. Rec. 60.

for hotel accommodations and meals while the expenses of his home go on without appreciable abatement.

IMPROVEMENTS AND BETTERMENTS. In computing net income, no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments or for furniture or fixtures made to increase the value of any property or estate.[43] This is a reasonable limitation, since amounts of capital invested in improvements and betterments add to the value of the property. The subject of this paragraph and the following paragraph is discussed more fully elsewhere in this book.[44]

RESTORATION OF PROPERTY. No deduction is allowed to citizens and residents for any amount expended in restoring property or making good the exhaustion thereof for which an allowance is or has been made.[45] This is also a reasonable limitation since if such property is subject to wear or tear and depletion, the additional amount so invested in the property may be taken into consideration in computing the allowance for depreciation and depletion.

INSURANCE ON EMPLOYEES. No deduction is permitted for any amount paid in premiums on any life insurance policy covering the life of any employee or any person financially interested in any trade or business carried on by citizens and residents, when the taxpayer is directly or indirectly a beneficiary under such policy.[46] This subject is more generally discussed elsewhere in this book.[47]

Credit of Dividends. For the purpose of computing the normal tax only, there may be deducted from net income amounts received as dividends from a corporation taxable upon its net income under the law, and amounts received as dividends from a personal-service corporation

43 Revenue Act of 1918, § 215 (b); Reg. 45, Art. 293.
44 See Chapter 26 on Deductions—In General.
45 Revenue Act of 1918, § 215 (c).
46 Revenue Act of 1918, § 215 (d).
47 See Chapter 26 on Deductions—In General.

out of earnings or profits upon which income tax has been imposed.[48]

Personal Exemption. The personal exemption is allowed in all cases to citizens and residents. It may be said to be an arbitrary sum allowed for personal, living or family expenses.[49] A corporation has no right to claim this exemption; a non-resident alien individual may secure personal exemption on certain conditions.[50] In the case of a single person the amount of the personal exemption is $1,000 and in the case of the head of the family or a married person living with husband or wife, $2,000. The husband and wife living together are permitted but one personal exemption of $2,000 against their aggregate net income; and in case they make separate returns; such personal exemption may be taken by either or divided between them.[51] A taxpayer receives a credit of $200 for each person (other than husband or wife), whether related to him or not and whether living with him or not, dependent upon and receiving his chief support from the taxpayer, provided the dependent is either (a) under the age of 18 years or (b) incapable of self-support because mentally or physically defective. The credit for dependents is based upon actual financial dependency and not mere legal dependency. It may accrue to a taxpayer who is not the head of a family. But a father whose children received half or more of their support from a trust fund or other separate source is not entitled to the credit.[52]

HEAD OF FAMILY. This phrase in the law is defined by ruling to include any person who actually supports and maintains one or more individuals who are closely connected with him (or her) by blood relationship, relation-

[48] Revenue Act of 1918, § 216 (a) (b); Reg. 45, Art. 301.

[49] Such expenses are expressly stated not to be deductible in the Revenue Act of 1918. See § 215 (a). See also Revenue Act of 1916, § 5 (a).

[50] Reg. 45, Art. 305. See Chapter 5 on Non-resident Aliens.

[51] Revenue Act of 1918, § 216 (c).

[52] Revenue Act of 1918, § 216 (d); Reg. 45, Art. 304. Formerly this exemption was limited to dependent *children*.

ship by marriage, or by adoption, and whose right to exercise family control and provide for these dependent individuals is based upon some moral or legal obligation.[53] Such head of a family is entitled to the same personal exemption as married persons. As indicated by the above definition, the head of a family may be a single or married person, a widow, widower, brother, sister, or other relative by blood, marriage or adoption.[54] The rulings hold that residence with the dependents is an essential factor in order to claim the exemption allowed to a head of a family but temporary absence will not destroy that status. Thus, if a father is absent on business or at war or a child, or other dependent is away only temporarily at school or on a visit, the common home being still maintained, the additional exemption applies. If, however, the dependent continuously makes his home elsewhere, his benefactor is not the head of a family, irrespective of the question of support.[55]

HUSBAND AND WIFE. A husband and wife living together are entitled to an exemption of $2,000 only against their aggregate net income, and in case they make separate returns, such personal exemption of $2,000 may be taken by either or divided between them.[56] In the case of a married man or married woman the joint exemption replaces the individual exemptions only if his wife lives with him or her husband lives with her. In the absence of continuous actual residence together, whether or not a man or woman has a wife or husband living with him or her within the meaning of the statute must depend on the character of the separation. If merely occasionally and temporarily a wife is away on a visit or a husband is away on business, the joint home being maintained, the additional exemption applies. The unavoidable absence of a wife or a husband at a sanitarium or asylum on ac-

[53] Reg. 45, Art. 302; T. D. 2427.
[54] Reg. 33 Rev., Art. 14.
[55] Reg. 45, Art. 302; T. D. 2692.
[56] Revenue Act of 1918, § 216 (c).

count of illness does not preclude claiming the exemption. If, however, the husband voluntarily and continuously makes his home at one place and the wife hers at another, they are not living together for the purpose of the statute, irrespective of their personal relations.[57]

RESIDENT ALIENS. Resident aliens claiming exemption because of families or wives residing abroad are not heads of families or married men or women with wives or husbands living with them within the meaning of the statute, and they are in no case entitled to more than their individual exemptions of $1,000.[58]

STATUS OF CLAIMANT. The status (single, married or head of a family) of the individual claiming the personal exemption is determined as of the close of the year.[59] Thus, where either husband or wife dies during the year, the survivor, in making a return at the end of the year, will be allowed the exemption applicable to single persons or heads of families, and the executor or administrator of the deceased, in making a return for the deceased, may claim the exemption according to the status of the deceased at the time of his death, from the net income received between the first of the year and the date of death no matter how short the period.[60] Where an individual makes a return for a period of less than twelve months by reason of changing from a calendar to a fiscal year basis for making returns, it seems that the personal exemption should be prorated. In the instructions appearing on the forms of individual returns for 1919 appears a statement indicating that these exemptions should be prorated if there was a change in the status of the taxpayer during the year, but there is nothing in the recent regulations to indicate a change in the long-established rule that the exemption depends upon the status of the taxpayer at

57 Reg. 45, Art. 303; T. D. 2692.
58 Reg. 45, Art. 302; T. D. 2692.
59 Reg. 33 Rev., Art. 14.
60 T. D. 2090; T. D. 2135; Reg. 33 Rev., Art. 14.

the end of the year; and nothing in the new law to indicate an intent on the part of Congress to change that rule.

NOT APPLICABLE TO SURTAX. The personal exemption is not to be deducted from the net income of the individual in assessing the surtax.[61]

Credit Against Tax. The amount of any income, war-profits and excess-profits taxes paid (or accrued) during the taxable year to any foreign country upon income derived from sources therein, is allowed as a credit against the tax of citizens, resident or non-resident. The amount of such taxes paid (or accrued) during the taxable year by a resident alien to a foreign country of which he is a citizen is allowed as a credit against his tax if such country in imposing such taxes allows a similar credit to citizens of the United States residing in such country. The amount of any income, war-profits and excess-profits taxes paid during the taxable year to any possession of the United States is allowed as a credit against the tax of all citizens and residents. In the case of any such citizen or resident who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or of the estate or trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be, is allowed as a credit. The credits specified in this paragraph are only allowed if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources within such foreign country or possession and all other information necessary for the computation thereof. If accrued taxes when paid differ from the amounts claimed as credits or if any tax paid is refunded provision is made that the taxpayer notify the Commissioner of such fact, in which case a redetermination of the tax paid is had, as is more particularly set forth in another chapter.[62]

61 Revenue Act of 1918, § 216; Reg. 45, Art. 301.

62 Revenue Act of 1918, § 222; Reg. 45, Arts. 381-384. See Chapter 33.

Fiscal Year. A citizen or resident is required to make returns and pay the tax on the basis of his annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping his books, unless (a) no such method of accounting has been employed, or (b) the method employed does not clearly reflect income. In the case of (a) and (b) the computation of net income is made on such basis and in such manner as in the opinion of the Commissioner does clearly reflect income. If the taxpayer's annual accounting period is other than a fiscal year or if the taxpayer has no accounting period or keeps no books his net income is computed on the basis of the calendar year. In the event of any change of the accounting period from fiscal year to calendar year or vice versa or from one fiscal year to another, net income is computed on the basis of such new accounting period. Reporting on the basis of a fiscal year was formerly a privilege accorded to corporations only. It is now a requirement applicable to all taxpayers if the accounting period of the taxpayer is a fiscal year. This subject is more fully treated in another chapter.[63]

Returns. For the purpose of assessing the tax a citizen or resident having a net income for the taxable year of $1,000 or more if single, or $2,000 or more, if the head of a family or married person living with husband or wife, is required to make a verified return stating specifically the items of his gross income and the deductions and credits to which he may be entitled.[64] In addition citizens and residents having less than the above amount of income may be required to make returns or statements sufficient to satisfy the Commissioner that they are not liable to tax.[65] The rules and regulations and general provisions

[63] Revenue Act of 1918, § 212 (b); Reg. 45, Arts. 21-26. See Chapter 2.

[64] Revenue Act of 1918, § 223; Reg. 45, Art. 401-405.

[65] Revenue Act of 1918, § 1305.

relating to such returns are dealt with in another chapter.[66]

Special Returns. In addition to the above mentioned returns citizens and residents are required to file certain special returns annually or at such times as the Commissioner may request, as follows:

INFORMATION AT THE SOURCE. Persons, in whatever capacity acting including lessees or mortgagors of real or personal property, fiduciaries,[67] and employers making payment to any individual, corporation or partnership of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments or other fixed or determinable gains, profits and income (other than payments described in the following paragraph) of more than $1,000 in any taxable year, are required to make returns in regard thereto under regulations of the Treasury Department, setting forth the amount of such payments and the names and addresses of the recipients.[68] This return is for the purpose of supplying the Treasury Department with information to be used in auditing the returns of the taxpayers to whom the income is paid, and is more fully discussed in a later chapter.[69]

REPORTS BY BROKERS. Those doing business as brokers[70] are required when called upon by the Commissioner of Internal Revenue to make a return showing the names of their customers with such details as to the profits, losses or other information which the Commissioner may

[66] See Chapter 34 on Returns.

[67] The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate. The term "person" includes individuals, partnerships and corporations. The term "corporation" includes associations, joint-stock companies and insurance companies (Revenue Act of 1918, §§ 1 and 200). See Chapter 8 on Fiduciaries.

[68] Revenue Act of 1918, § 256; Reg. 45, Arts. 1071-1079.

[69] See Chapter 39 on Information at the Source.

[70] The Revenue Act of 1916 applied only to "brokers on any exchange or board of trade or other similar place of business."

require as to each of such customers as will enable the Commissioner of Internal Revenue to determine whether all income tax due on the profits or gains of such customers has been paid.[71] This report is for the purpose of information at the source and is more fully discussed in a later chapter.[72]

Payment of Tax. The rules in regard to the assessment and payment of taxes in the case of citizens or residents are discussed in another chapter.[73]

Examination of Books. The books, papers, records or memoranda of taxpayers are subject to examination by any revenue agents or inspectors designated by the Commissioner of Internal Revenue for the purpose of ascertaining the correctness of returns which have been made, or making a return where none has been made in accordance with and subject to rules which are discussed at length in another chapter.[74]

Penalties. Penalties for failing or refusing to make returns, supply information, pay or collect any tax, or for wilfully attempting in any manner to defeat or evade the income tax are discussed in another chapter.[75]

Tax Not Withheld at Source. The tax is not withheld at the source on payments to citizens and residents. A provision of the law requires withholding at the source in the case of corporate bonds and mortgages containing a so-called "tax-free covenant."[76] This, however, is not intended as a provision requiring withholding, but is intended to require the corporation to assume the burden of a part of the tax for the bondholder. Consequently in such cases no tax is actually deducted, but the corporation assumes for the bondholder the payment of the normal tax to the extent of 2% of such interest, which

71 Revenue Act of 1918, § 255; Reg. 45, Art. 1061.
72 See Chapter 39 on Information at the Source.
73 See Chapter 35 on Assessment and Payment of the Tax.
74 See Chapter 37 on Examination of Taxpayer's Books.
75 See Chapter 36 on Penalties and Compromises.
76 Revenue Act of 1918, § 221 (b).

amount the bondholder reports as though the tax had been actually withheld, the remainder of the normal tax being reported as not having been withheld. A further discussion of collection at the source is contained in the chapter on that subject.[77]

Duty to Withhold Tax at Source. A citizen or resident paying fixed or determinable gains, profits or income (a) to non-resident alien individuals or (b) to foreign corporations not engaged in trade or business within the United States and not having any office or place of business in this country, is required to withhold 8% in the case of payments under (a) and 10% in case of payments under (b) as set forth in a subsequent chapter.[78]

Collection of Foreign Items. Citizens or residents undertaking as a matter of business or for profit, the collection of foreign items, are required to obtain a license from the Commissioner of Internal Revenue as indicated in a later chapter.[79]

77 See Chapter 40.
78 Revenue Act of 1918, §§ 221 and 237. See Chapter 40.
79 See Chapter 39.

CHAPTER 5

NON-RESIDENT ALIENS

The law imposes a tax upon the net income received by non-resident alien individuals "from sources within the United States, including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States." The term "non-resident aliens," as used in several places in the 1916 Law, was not defined therein, but clearly referred to individuals only and not to partnerships, corporations, or associations. The Revenue Act of 1918, however, removes all doubt by using the expression "non-resident alien *individuals*."[1] The expression "non-resident aliens" is used in this chapter to mean only non-resident alien individuals. Ordinarily it is a simple matter to determine whether an individual is or is not a non-resident alien; he falls into this class if he is neither a citizen nor a resident. Any individual who is a citizen of any possession of the United States (but not otherwise a citizen of United States) and who is not a resident of the United States is subject to taxation for income tax purposes, as to income derived from sources within the United States, and his tax is computed and paid in the same manner and subject to the same conditions as non-resident aliens who are citizens or subjects of foreign countries.[2] The term "non-

[1] Revenue Act of 1918, §§ 210 and 213 (c); Reg. 45, Art. 3.

[2] Revenue Act of 1918, § 260. Income of citizens and residents of Porto Rico or the Philippines is taxed in those jurisdictions in ac-

resident alien," therefore, is used in this chapter to include any non-resident citizens of any possession of the United States. Difficulty may arise in determining whether an individual is or is not a non-resident alien, where a non-resident citizen naturalized or native has resided abroad for a period sufficient to raise a presumption that he has abandoned his citizenship,[3] and again where an alien has resided in this country for a period so long as to raise a presumption of residence. In either of these cases the intent of the individual is important. The Treasury Department holds that the status of a non-resident native or naturalized citizen remains unchanged until some affirmative action is taken, or the right to citizenship is forfeited by some overt act.[4] When any naturalized citizen has left the United States and resided for two years in the foreign country from which he came, or for five years in any other foreign country, he is presumed to have lost his American citizenship; but this pre-

cordance with the provisions of the Revenue Act of 1916, as amended, the legislatures of Porto Rico and the Philippines having power to amend, alter, modify or repeal that law in their respective jurisdictions (Revenue Act of 1918, § 261).

[3] The Act of March 2, 1907, provides, briefly, that any American citizen becomes an alien by becoming naturalized in a foreign state or taking an oath of allegiance to any foreign state. A naturalized citizen residing for two years in the country from which he came or for five years in any other foreign country, is presumed to have renounced his American citizenship in the absence of satisfactory evidence to the contrary. A woman assumes the nationality of her husband, but may resume her original citizenship on becoming a widow; she assumes or retains her American citizenship as a widow if, living abroad, she registers with a United States consul, or without formal action if she resides here. Minor children of naturalized citizens are deemed to be citizens from the time they begin to reside permanently in this country. Children born outside of the United States of citizens, and continuing to reside abroad must at the age of 18 declare their intention as to citizenship. Determination of citizenship by the State Department under this Act is not conclusive upon the Treasury Department; other factors may also be considered, as indicated in the text.

[4] T. D. 2135.

sumption does not apply to residence abroad while the United States is at war. An Italian, who has come to the United States and filed his declaration of intention of becoming a citizen, but who has not yet received his final citizenship papers, is an alien. A Swede, who, after having come to the United States and become naturalized here, returned to Sweden and resided there for two years prior to April 6, 1917, is presumed to be once more an alien.[5] On the other hand, an alien, coming to the United States with the intention of becoming a resident within the meaning and intent of the income tax statute, may indicate that fact and thereupon will be taxed as a resident, regardless of the length of time he has been here.[6] The tests as to the residence of aliens located within this country have been set forth in another chapter.[7]

Extent to Which Non-Resident Aliens Are Taxable. Non-resident aliens are subject to the normal tax and the surtax imposed by the Revenue Act of 1918, upon their net income received from all sources within the United States, including interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise, dividends received from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States.[8] Non-resident aliens are not taxed at

5 Reg. 45, Art. 4.

6 Reg. 45, Art. 362; T. D. 2242. See Chapter 4 on Citizens and Residents for status of resident aliens.

7 See Chapter 3 on Individuals to Whom the Law is Applicable.

8 Revenue Act of 1918, §§ 210 and 213 (c); Reg. 45, Art. 3. The 1913 Law, which was repealed by the 1916 Law, imposed a tax on the net income of non-resident aliens "from all property owned and of every business, trade, or profession carried on in the United States." This language was held, under two opinions of the Attorney General, not to include interest or dividends received by non-resident alien investors from domestic corporations, but on March 21, 1916, the Treasury Department reversed this holding and thereafter claimed the tax from non-resident aliens on the classes of income in question. (T. D. 2313.) In DeGanay v. Lederer, 239 Fed. 568, the

the lower rate of normal tax upon the first $4,000 of their taxable net income as are citizens or residents, but their entire taxable net income is subject to a normal tax of 12% for the taxable year 1918 and 8% in succeeding years.[9]

Income from Sources Within the United States. The words "sources within the United States" are not defined in the law and their interpretation raises many difficult questions. The term is very broad and was intended to include income of all kinds from sources over which this country has jurisdiction. No cases as yet have arisen in the courts involving construction of the phrase. The most comprehensive ruling defining gross income from sources within the United States includes in the term, in addition to the items specified in the statute, rentals, and royalties from property and income from business carried on in the United States, income from isolated transactions or activities directly resulting in gain, carried on within the United States by a non-resident or his representative in person, interest on deposits in banks located within the United States, income from capital otherwise invested in the United States, and income from services rendered or labor performed within the United States.[10] The tax does not apply to charter money received by a foreign owner for a vessel operated between the United States and foreign ports, if the making of the charter contract grows out of no solicitation or similar commercial activity by the owner or his representative in person within the United States.[11] A corporation located at Singapore, incorporated under the laws of India, having no office or agent in the United States, was engaged in the commission business,

District Court held a non-resident alien taxable on such income if the stock certificates and bonds were kept in this country, as then they acquired a situs here for purpose of the income tax. (This case is now No. 319 on the docket of the Supreme Court.) The language of the 1916 Law and the present law expressly included such income, regardless of where the securities might be kept.

9 Revenue Act of 1918, § 210 (a); Reg. 45, Art. 2.

10 Reg. 45, Art. 91.

11 Reg. 45, Art. 92.

and during the year 1917 sold at Singapore and in nearby countries certain products of manufacturing establishments in the United States. The purchase price of the goods was transmitted by the purchasers to the manufacturers and American houses direct, and when the money was received in the United States a commission was paid out of the proceeds of sale to the Singapore corporation. It was held that this commission was not income derived from sources within the United States; also that should an American corporation receive these commissions from the manufacturer and transmit them to the Singapore corporation, where it simply acted as agent for the Singapore corporation in receiving and transmitting such commissions and retained no part thereof for its own use, it need not report them as its own income.[12] The term "income" includes gains, profits and income derived from all salaries, wages or compensation for personal services, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales or dealings in property whether real or personal growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or income derived from any sources whatever.[13] Non-resident aliens are not taxed on income specified in the law to be exempt.[14]

INCOME FROM BUSINESS BRANCHES. Where a non-resident alien establishes a branch of his business in this country the net income of that branch is subject to tax, and this would seem to be true even though a portion of

[12] Letter from Treasury Department dated April 20, 1918; I. T. S. 1918, ¶ 3324.

[13] Revenue Act of 1918, § 213 (a). Compare this section with § 2 (a) of the Revenue Act of 1916.

[14] Revenue Act of 1918, § 213. Exempt income is generally exempt regardless of the status of the recipient. See Chapter 16 for a further discussion of this point and the exceptions to such general rule.

that income may have been received by the branch from business done in foreign countries, although the precise point is as yet unsettled. If two or more branches are established here, the total net income from all is taken together for purpose of assessment. The income of all branches should be reported by the principal branch in its district, the other branches not being assessable in their respective districts.[15]

DIVIDENDS. Non-resident aliens are not subject to the normal tax on income received as dividends from a corporation taxable under the law upon its net income. They are also not subject to the normal tax on amounts received as dividends from a personal-service corporation out of earnings or profits upon which income tax has been imposed. They must, however, in order to secure the credit of such dividends, file a return of their total net income received from all sources, corporate or otherwise, in the United States including the dividends in question.[16] If the total taxable income of all kinds from sources within the United States, together with such dividends and interest as are allowed to be credited for purposes of the normal tax, and together with any personal exemption which may be allowed, exceeds $5,000, the surtax must be paid at the prescribed rates.[17] The exemption of dividends from the normal tax applies not only to dividends received direct from a corporation, but also to dividends received through the medium of fiduciaries or partnerships.[18] Dividends of non-resident foreign corporations, that is, corporations not engaged in trade or business within the United States and not having any office or place of business in this country, are not taxable in the

15 Generally, the rules applying to foreign corporations as to income from business done in this country apply equally to non-resident alien individuals. See Chapter 14 on Foreign Corporations.

16 Revenue Act of 1918, §§ 216 and 217.

17 See Chapter 2 on The Income Tax Rates.

18 See Chapter 23 on Income from Dividends for a further discussion of this subject.

hands of a non-resident alien, even though such dividends may be payable in this country.[19] In two provisions of the 1916 Law[20] non-resident aliens were excepted from the requirements of making reports on and paying the surtax on "such income (income derived from dividends on the capital stock or from the net earnings of any corporation) derived from sources without the United States." Although such language was not construed by the courts or by any regulation, it undoubtedly applied to dividends received from foreign corporations where the earnings of such foreign corporations were derived from sources without the United States even though the dividends were payable in this country, and there seems to be ground for the contention that it also applied with equal force whether the corporation was foreign or domestic. Under the present law it is provided[21] that in the case of non-resident aliens "gross income includes only the gross income from sources within the United States, including * * * and including dividends from *resident* corporations." It may, therefore, be said this language removes the doubt existing under the provisions of the 1916 Law, and places the taxability of non-resident aliens in respect to dividends from corporations on the ground of the residence of the corporation paying the dividends. Dividends on stock of corporations organized in the United States but doing no business in the United States and owning no property therein are held not to be taxable when paid to non-resident aliens.[22]

INTEREST. Non-resident aliens are taxable upon all interest on bonds, notes or other interest-bearing obligations

19 Revenue Act of 1918, § 213 (c). See also T. D. 2012, T. D. 2030, T. D. 2313, T. D. 2325; Letter from Treasury Department dated April 5, 1916, I. T. S. 1918, ¶ 62. See also T. D. 2325 and T. D. 2012.

20 Revenue Act of 1916, §§ 1 (b) and 8 (b).

21 Revenue Act of 1918, § 213 (c).

22 Reg. 45, Art. 92. The English law taxes a British company which has permanently located its business and seat of management abroad only with respect to the profits of the English shareholders.

of *residents* in this country, corporate or otherwise, but for the purpose of the normal tax they are entitled to a credit on any amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation which is included in gross income.[23] In order to obtain such credit, they must file a return of their total income received from all sources, corporate or otherwise, in the United States.[24] Interest received from a non-resident, corporate or otherwise, is not taxable. Interest upon notes of corporations organized in the United States, but doing no business and owning no property therein is not taxable when paid to non-resident aliens.[25]

INTEREST UPON OBLIGATIONS OF THE UNITED STATES. It has been specifically provided[26] that notwithstanding the provisions of the Second Liberty Bond Act[27] as amended by the Third Liberty Bond Act[28] or of the War Finance Corporation Act[29] bonds and certificates of indebtedness of the United States, payable in any foreign money or foreign moneys and bonds of the War Finance Corporation, payable in any foreign money or foreign moneys exclusively or in the alternative shall be exempt, if and to the extent expressed in such bonds at the time of their issue with the approval of the Secretary while beneficially owned by a non-resident alien (or a foreign corporation, partnership or association) not engaged in business in the United States, both as to principal and interest, from any and all taxation now or hereafter imposed by the United States, any state or any of the possessions of the United States or by any taxing authority.

INTEREST ON BANK DEPOSITS. Where banking houses located in this country, carrying deposits for non-resident

23 Revenue Act of 1918, §§ 213 (c) and 216 (b)
24 Revenue Act of 1918, § 217.
25 Reg. 45, Art. 92.
26 Act of July 9, 1918 (Public No. 192), § 3.
27 Act of September 24, 1917 (Public No. 43).
28 Act of April 4, 1918 (Public No. 120).
29 Act of April 5, 1918 (Public No. 121).

aliens, credit such accounts with interest thereon, such interest must be included in the recipient's income tax return for the year in which he receives the interest or in which it is credited to an account against which he may draw.[30] Under the 1916 Law, since October 4, 1917, the bank has been required to withhold the normal tax of 2% on such interest when paid to non-resident aliens.[31] The rule will probably prevail under the present law except that the rate of withholding will be increased to 8% in the case of non-resident alien individuals.

SALARIES PAID BY RESIDENT EMPLOYERS. Under the 1913 Law it was held that compensation paid to non-resident aliens for services rendered in a foreign country, including business and traveling expenses, was not taxable.[32] The 1916 Law by imposing a tax on "income from all sources within the United States" raised a question as to the taxability of such compensation, but it was held that salaries, wages, commissions and rents paid by domestic corporations, resident individuals or partnerships to non-resident alien employees for services rendered entirely in a foreign country and for property located in a foreign country were not subject to income tax in the hands of the recipient as from sources within the United States.[33] The Treasury Department has issued a similar ruling under the present law.[34]

INCOME RECEIVED FROM FIDUCIARIES. Where a non-resident alien is the beneficiary of a trust, or of the estate of a deceased person, or is the recipient of income from any property held by another, such income is taxable to the extent that it arises from sources within the United States.

30 Reg. 45, Art. 91.

31 T. D. 2652. Letter from Treasury Department dated February 4, 1918; I. T. S. 1918, ¶ 3077. Prior to the above ruling, banks were not required to withhold tax on such interest or to make any return of the amount paid thereon to any depositor (Letter from Treasury Department dated June 29, 1917; I. T. S. 1918, ¶ 177).

32 T. D. 2152.

33 Reg. 33 Rev., Art. 32.

34 Revenue Act of 1918, § 213; Reg. 45, Art. 92.

The intervention of an agent, trustee or other fiduciary between the non-resident alien and the source of the income does not make income subject to taxation, which otherwise would not be taxable, nor does it serve to relieve from taxation income, which otherwise would be taxed.[35] Dividends, for instance, would not be subject to the normal tax for the reason that they are paid to a trustee and by him distributed to non-resident aliens.[36] Similarly, exempt income is not made taxable by passing through the hands of a fiduciary to the beneficiary.[37] One important class of exempt income from estates is gifts, legacies, bequests, etc., the principal sum being exempt, but the income therefrom being taxable.[38] Where a non-resident alien is a trustee, or other fiduciary, of an estate deriving income from sources within the United States, he is charged with the duty of making a return of such income.[39]

INCOME FROM PARTNERSHIPS. Non-resident aliens, who are members of partnerships deriving all their income from sources within this country, are taxable on their distributive shares.[40] If a partnership derives only part of its income from sources within the United States, non-resident alien partners are taxable only on that part of their respective distributive shares of the profits which represent income of the partnership from such sources.[41]

35 Letter from Treasury Department dated March 25, 1915; I. T. S. 1918, ¶ 110.

36 Letter from Treasury Department dated April 5, 1916; I. T. S. 1918, ¶¶ 32, 62, and 873.

37 Exempt income is not reported by the fiduciary as income accruing to the estate for the purpose of the tax. See Revenue Act of 1918, §§ 219 (b), 212 (a) and 213.

38 See Chapter 25 on Income from Miscellaneous Sources. See also Revenue Act of 1918, § 213 (a) 3.

39 Letter from Treasury Department dated December 28, 1916; I. T. S. 1918, ¶ 115. See Chapter 9 on Foreign Fiduciaries.

40 Revenue Act of 1918, § 218. See Chapter 10 on Partnerships and Personal Service Corporations.

41 This is one of the many questions on which the Treasury Department has not as yet made any public statement of its position. The status of a partner differs from that of a stockholder in a corpora-

aliens, credit such accounts with interest thereon, such interest must be included in the recipient's income tax return for the year in which he receives the interest or in which it is credited to an account against which he may draw.[30] Under the 1916 Law, since October 4, 1917, the bank has been required to withhold the normal tax of 2% on such interest when paid to non-resident aliens.[31] The rule will probably prevail under the present law except that the rate of withholding will be increased to 8% in the case of non-resident alien individuals.

SALARIES PAID BY RESIDENT EMPLOYERS. Under the 1913 Law it was held that compensation paid to non-resident aliens for services rendered in a foreign country, including business and traveling expenses, was not taxable.[32] The 1916 Law by imposing a tax on "income from all sources within the United States" raised a question as to the taxability of such compensation, but it was held that salaries, wages, commissions and rents paid by domestic corporations, resident individuals or partnerships to non-resident alien employees for services rendered entirely in a foreign country and for property located in a foreign country were not subject to income tax in the hands of the recipient as from sources within the United States.[33] The Treasury Department has issued a similar ruling under the present law.[34]

INCOME RECEIVED FROM FIDUCIARIES. Where a non-resident alien is the beneficiary of a trust, or of the estate of a deceased person, or is the recipient of income from any property held by another, such income is taxable to the extent that it arises from sources within the United States.

30 Reg. 45, Art. 91.

31 T. D. 2652. Letter from Treasury Department dated February 4, 1918; I. T. S. 1918, ¶ 3077. Prior to the above ruling, banks were not required to withhold tax on such interest or to make any return of the amount paid thereon to any depositor (Letter from Treasury Department dated June 29, 1917; I. T. S. 1918, ¶ 177).

32 T. D. 2152.

33 Reg. 33 Rev., Art. 32.

34 Revenue Act of 1918, § 213; Reg. 45, Art. 92.

The intervention of an agent, trustee or other fiduciary between the non-resident alien and the source of the income does not make income subject to taxation, which otherwise would not be taxable, nor does it serve to relieve from taxation income, which otherwise would be taxed.[35] Dividends, for instance, would not be subject to the normal tax for the reason that they are paid to a trustee and by him distributed to non-resident aliens.[36] Similarly, exempt income is not made taxable by passing through the hands of a fiduciary to the beneficiary.[37] One important class of exempt income from estates is gifts, legacies, bequests, etc., the principal sum being exempt, but the income therefrom being taxable.[38] Where a non-resident alien is a trustee, or other fiduciary, of an estate deriving income from sources within the United States, he is charged with the duty of making a return of such income.[39]

INCOME FROM PARTNERSHIPS. Non-resident aliens, who are members of partnerships deriving all their income from sources within this country, are taxable on their distributive shares.[40] If a partnership derives only part of its income from sources within the United States, non-resident alien partners are taxable only on that part of their respective distributive shares of the profits which represent income of the partnership from such sources.[41]

35 Letter from Treasury Department dated March 25, 1915; I. T. S. 1918, ¶ 110.

36 Letter from Treasury Department dated April 5, 1916; I. T. S. 1918, ¶¶ 32, 62, and 873.

37 Exempt income is not reported by the fiduciary as income accruing to the estate for the purpose of the tax. See Revenue Act of 1918, §§ 219 (b), 212 (a) and 213.

38 See Chapter 25 on Income from Miscellaneous Sources. See also Revenue Act of 1918, § 213 (a) 3.

39 Letter from Treasury Department dated December 28, 1916; I. T. S. 1918, ¶ 115. See Chapter 9 on Foreign Fiduciaries.

40 Revenue Act of 1918, § 218. See Chapter 10 on Partnerships and Personal Service Corporations.

41 This is one of the many questions on which the Treasury Department has not as yet made any public statement of its position. The status of a partner differs from that of a stockholder in a corpora-

PROFITS ON THE SALE OF PROPERTY. Non-resident aliens are taxable on profits and gains from the sale of real or personal property located in the United States.[42] Where sales of intangible personal property, for example, stocks, bonds, notes, etc., of domestic corporations or residents are made in the United States, the profit is held to be taxable and the custodian of the securities here is charged with the duty of reporting the profit of the non-resident alien, for which purpose he must place himself in possession of all the facts necessary to an accurate determination of the amount of profit or loss in the transaction.[43] If a sale of such intangible personal property is made in a foreign country by a non-resident alien, it does not seem that the seller would be taxable on the gain or profit therefrom.

INCOME FROM ROYALTIES. Royalties paid to non-resident aliens under an agreement of purchase of certain patent rights, the patents being based upon the quantity of goods produced by the use of such patents have been held to be income accruing to non-resident aliens by reason of property owned or business carried on within the United States.[44]

OTHER INCOME. Gains or profits and income from any source whatever in the United States (except exempt income) are taxable in the hands of non-resident aliens.[45] The questions which arise in this connection are with respect to the source of the income, rather than with respect to its character. Many of the questions will be settled only by the slow and gradual process of development of

tion, since in the case of a partnership there is no separate entity interposed between the recipient of the income and its original source. See U. S. v. Coulby, 251 Fed. 982.

42 Revenue Act of 1918, § 213 (a) (c). See Chapter 20 on Income from Sales or Dealings in Property, for the method of computing taxable gains on the sale of property.

43 Letter from Treasury Department dated May 31, 1916; I. T. S. 1918, ¶ 104.

44 T. D. 2137. See Reg. 45, Art. 91.

45 Revenue Act of 1918, § 213 (a).

the law, through litigation and by specific rulings of the Treasury Department on cases brought to its attention.[46]

Deductions Allowed in Computing Net Income. A non-resident alien is required to report all his taxable income from sources within this country, but from the gross amount so reported is entitled to make certain deductions before the tax is assessed on the remainder. The deductions are similar in kind to those allowed to residents and citizens but, in general, are confined to expenditures connected with the income subject to tax or limited by the proportion of the individual's income arising from sources within this country.[47] An extended discussion of deductions is contained in other chapters, the discussion in this chapter being limited to the provisions which apply particularly to non-resident aliens.

BUSINESS EXPENSES. Non-resident aliens may deduct from their gross income all ordinary and necessary expenses paid or incurred in carrying on any trade or business subject to the same general provisions applicable to citizens and residents,[48] but only if and to the extent that they are connected with income arising from a source within the United States and as properly apportioned and allocated with respect to sources of income within and without the United States.[49] The method of apportioning and allocating general deductions to income from sources in this country is required by the law to be prescribed by the Commissioner, but no specific rulings have as yet appeared under the 1918 Law. Where the business or trade

[46] It will be noted that § 213 (c) of the Revenue Act of 1918 goes further than the 1916 Law in expressly citing special kinds of income as being "from sources within the United States," and Reg. 45, Art. 91 expand the definition beyond all previous regulations. But the phrase "sources within the United States" is too broad and indefinite for practical certainty and it naturally results in imposing the tax on incomes in cases where there is serious question as to the moral right or economic wisdom of so doing.

[47] Revenue Act of 1918, § 214 (b).

[48] Revenue Act of 1918, § 214 (a) 1.

[49] Revenue Act of 1918, § 214 (b).

carried on in this country is by means of separate and distinct branches the expenses are readily determined. Where the accounts are kept at, and the business is under the supervision of, the home office abroad, the home office expenses connected therewith, if segregated, may be included. If not segregated, the Treasury Department has permitted the deduction of such proportion of the entire expenses of the business as the gross income from this country bears to the entire gross income from business done both within and without the United States.[50]

INTEREST. Non-resident aliens may deduct the proportion of interest paid or accrued within the taxable year on their indebtedness which the amount of their gross income from sources within the United States bears to the amount of their gross income from all sources within and without the United States.[51] For instance, if half the amount of the gross income of a non-resident alien for the taxable year is from sources within the United States he may deduct one half of the entire amount of interest he has paid during the taxable year on his indebtedness. To obtain this deduction it is required that the claimant report his total income received from all sources, corporate or otherwise, in the United States, so that the Commissioner may calculate the amount of deduction to which he may be entitled.[52] The one limitation on the amount of interest which may be deducted by non-resident aliens is the same as the limitation in respect to citizens or residents, namely, interest paid or accrued within the taxable year on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States, issued after September 24, 1917) the interest upon which is wholly exempt from taxation as income to the taxpayer.[53]

TAXES. Non-resident aliens may deduct taxes paid or

50 See Chapter 28 on Deduction of Business Expenses.
51 Revenue Act of 1918, § 214 (a) 2.
52 Revenue Act of 1918, § 217.
53 Revenue Act of 1918, § 214 (a) 2.

accrued within the taxable year to taxing authorities in this country in the same manner and subject to the same limitation as citizens or residents. They may also deduct taxes imposed by the authority of any foreign country upon property or business (except income, war profits and excess profits taxes and taxes assessed against local benefits of a kind tending to increase the value of the property assessed) upon property or business, to the extent that such taxes are connected with income arising from a source within the United States and as they are properly apportioned and allocated with respect to sources of income within and without the United States.[54]

LOSSES SUSTAINED IN TRADE. Non-resident aliens may deduct losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business; such losses, however, may only be deducted if and to the extent that they are connected with income arising from a source within the United States and must be properly apportioned and allocated with respect to sources of income within and without the United States.[55]

NET LOSSES OF ANY BUSINESS. Non-resident aliens may deduct net losses resulting from (1) the operation of any business regularly carried on by them, or (2) the *bona fide* sale by them of a plant, buildings, machinery, equipment, or other facilities constructed, installed or acquired by them on or after April 6th, 1917, for the production of articles contributing to the prosecution of the war with Germany in the same manner as citizens or residents. This subject is more fully treated elsewhere in this book.[56]

LOSSES NOT SUSTAINED IN TRADE. Non-resident aliens

54 Revenue Act of 1918, § 214 (a) 3. See paragraph on Taxes in Chapter 4 on Citizens and Residents.

55 Revenue Act of 1918, § 214 (a) 4, and (b). See paragraph on Losses Sustained in Trade in Chapter 4 on Citizens and Residents for a discussion of the term "trade or business" and other rulings in respect to such losses.

56 See Chapter 4 on Citizens and Residents and Chapter 30 on Deduction of Losses.

may deduct losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction within the United States, entered into for profit, though not connected with the trade or business.[57] This provision is a substantial departure from the corresponding provision of the 1916 Law which limited the deduction of losses in transactions entered into for profit, though not connected with trade or business, to an amount not in excess of the profits arising from similar transactions. This change is discussed at length in another chapter.[58]

LOSSES OF PROPERTY FROM FIRE, STORMS, ETC. Non-resident aliens may deduct losses sustained during the taxable year of property within the United States not connected with the trade or business, if arising from fires, storms, shipwreck or other casualties, or from theft, and if not compensated for by insurance or otherwise.[59]

LOSSES IN VALUE OF INVENTORY. The provision of the Revenue Act of 1918, permitting the deduction of losses in value of inventory, is applicable to non-resident aliens to the extent that such losses are connected with income arising from a source within the United States. Such losses, when deductible, must be properly apportioned and allocated to sources of income within and without the United States.[60]

WORTHLESS DEBTS. Non-resident aliens may deduct debts ascertained to be worthless and charged off within the taxable year subject to the same limitations as citizens and residents, except that such debts must be connected with income arising from a source within the United States and must be properly apportioned and al-

57 Revenue Act of 1918, § 214 (a) 5.

58 See paragraph Losses not Sustained in Trade in Chapter 4 on Citizens and Residents.

59 Revenue Act of 1918, § 214 (a) 6.

60 Revenue Act of 1918, § 214 (a) 12, (b). See Chapter 5 on Citizens and Residents and Chapter 30 on Deduction of Losses.

located to sources of income within and without the United States.[61]

DEPRECIATION. Non-resident aliens are permitted a reasonable allowance for the exhaustion, wear and tear of property used in their trade or business, including a reasonable allowance for obsolescence, under the same rules and regulations as apply to citizens and residents except that any deduction for depreciation will be allowed only if and to the extent that the property in respect of which the depreciation is claimed is connected with income arising from a source within the Uinted States and a proper apportionment and allocation of this deduction is determined with respect to sources of income within and without the United States.[62]

DEPLETION OF NATURAL RESOURCES. A non-resident alien is permitted the same allowance in the case of the depletion of mines, oil and gas wells, other natural deposits, and timber, and for depreciation of improvements as is allowed to citizens and resident individuals and domestic corporations except that the subject of depletion must be connected with income arising from a source within the United States and a proper apportionment and allocation of the deduction with respect to sources of income within and without the United States must be determined.[63]

CONTRIBUTIONS TO CHARITIES. Non-resident aliens may deduct from their gross income contributions or gifts made within the taxable year, subject to the same limitations which apply in the case of citizens and residents, except that the donee corporations or associations must be domestic. Contributions or gifts by non-resident aliens to the Vocational Rehabilitation Fund are also deductible. But the total of all contributions so deducted cannot be in

61 Revenue Act of 1918, § 214 (a) 7 and (b). See paragraph on Worthless Debts in Chapter 4 on Citizens and Residents.

62 Revenue Act of 1918, § 214 (a) 8 and (b). See Chapter 32 on Depreciation. See also paragraph on Depreciation in Chapter 4 on Citizens and Residents.

63 Revenue Act of 1918, § 214 (a) 10 and (b). See Chapter 32.

excess of 15% of the net income of such non-resident aliens including the amount of such contribution or gift.[64]

AMORTIZATION. Non-resident aliens are permitted a reasonable deduction of such part of the cost of buildings, machinery, equipment or other facilities constructed, erected, installed or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the war with Germany and vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the war with Germany as has been borne by them but not again including any amount otherwise allowed under the Revenue Act of 1918 or previous income tax laws as a deduction in computing net income. The subject of such amortization, however, in the case of non-resident aliens must be connected with income arising from a source within the United States and a proper apportionment and allocation of this deduction with respect to sources of income within and without the United States must be determined.[65] Certain rules pertaining to the re-examination of returns and redetermination of the amount of tax for purposes of amortization and also pertaining to the collection of underpayments and credit or refund of over-payments are set forth elsewhere in this book.[66]

CREDIT OF DIVIDENDS. Non-resident aliens are permitted a credit of certain dividends for the purpose of the normal tax only in certain cases. This subject is discussed elsewhere in this chapter.[67]

CREDIT OF INTEREST. Non-resident aliens are permitted a credit for purposes of the normal tax of interest upon obligations of the United States and bonds issued by the War Finance Corporation which is included in gross in-

64 Revenue Act of 1918, § 214 (a) 11; Reg. 45, Art. 271. Prior to the enactment of the Revenue Act of 1918 gifts or contributions were in no case deductible by non-resident aliens.

65 Revenue Act of 1918, § 214 (a) 9 and (b).

66 See Chapter 31.

67 See paragraph on Dividends, supra, page 69.

come. This subject is discussed elsewhere in this chapter.[68]

TAX WITHHELD AT THE SOURCE. As the law requires the normal tax to be withheld by the one in this country who pays fixed or determinable income to a non-resident alien,[69] a due credit for the amount so withheld may be claimed in filing the annual return. The non-resident alien should therefore keep a record of the amount of tax withheld at the source from time to time on payments made to him, and should report the aggregate sum so withheld in his annual return, in order that the normal tax may not be twice collected with respect to the same income.

PERSONAL EXEMPTION. A non-resident alien individual, similarly to a citizen or resident, is entitled for the purpose of the normal tax to a personal exemption, and $200 for each dependent, except that if he is a citizen or subject of a country which imposes an income tax the personal exemption is allowed only if his country allows a similar credit to citizens of the United States not residing in such country. By "similar credit" is meant the same personal exemption or credit for dependents to citizens of the United States as is allowed citizens of such country, not necessarily the same amount as in the United States statute.[70]

Returns. A non-resident alien individual must make or have made for him a full and accurate return of income received from sources within the United States, regardless of amount, unless the tax on such income has been fully paid at the source.[71] A non-resident alien may

68 See paragraph on Interest, supra, page 70.

69 See Chapter 40 on Collection of the Tax at the Source.

70 Reg. 45, Art. 305.

71 Revenue Act of 1918, § 223; Reg. 45, Art. 403. Form 1040 (revised) is used for this purpose. Under the 1916 Law the same form (Form No. 1040) was prescribed for the use of all individuals, resident and non-resident. A non-resident alien made such changes as were necessary to indicate that the return covered in his case only income from sources within this country. The additional information

have had the tax on all his income arising from sources within this country withheld at the source although he may be taxable on a lesser amount by reason of expenses, interest, losses and other deductible items. Only by filing a return may he claim these deductions and secure the return to him of any amount withheld in excess of his tax liability. Such return must include such information as may be deemed necessary by the Commissioner for the calculation of any deductions and credits to which he may be entitled. But, unless the country of which the non-resident alien is a subject or citizen imposes an income tax and does not allow a subject or citizen of the United States not residing therein a similar credit, the personal exemption and the credit for dependents may be allowed to non-resident aliens in the discretion of the Commissioner without the filing of the above return of income from all sources within the United States, such credits being received in such case by the filing of a claim therefor with the withholding agent.[73] The Commissioner has ruled, however, that for the present the benefit of the credits allowed against net income for the purpose of the normal tax may not be received by a non-resident alien by filing a claim with the withholding agent, but only by claiming them upon filing a return of income. Unless a non-resident alien individual renders a return of income, the tax will be collected on the basis of his gross income (not his net income) from sources within the United States. Where non-resident aliens have various sources of income within the United States, so that from any one source or from all sources combined the amount of income calls for the assessment of a surtax, and a return of income is not filed by or on behalf of a non-resident alien, the Commissioner will cause a return of income to be made and include therein the income of such non-resident alien from all sources concerning which he

required in order to compute the amount of deductible interest (deductions and credits under the present law) was made on a supplementary statement attached to the return.

[73] Revenue Act of 1918, § 217.

has information, and he will assess the tax and collect it from one or more of the sources of income within the United States of such non-resident alien, without allowance for deductions or credits.[73] For the purpose of obtaining a refund of any amount withheld in excess of his tax liability as above indicated, a non-resident alien was required under the 1916 Law to attach to his return a statement giving the names and post office addresses of all persons, firms or corporations who had withheld the tax on income paid to him during the year, and the amount of tax withheld by each respectively.[74] Under the present law it is ruled that there should be attached to the return a statement showing accurately the amounts of tax withheld with the names and post office addresses of all withholding agents.[75] Upon the basis of such information the Treasury Department thereupon orders the withholding agent to release the excess withheld.[76]

RETURNS BY AGENTS. If a non-resident alien is unable to make his own return it may be made on his behalf by a duly authorized agent and in proper cases may also be made by guardians or other persons charged with the care of the person or property of such taxpayer.[77] It should be borne in mind that a non-resident alien may have an agent in this country for the purpose of making returns without having appointed one. The responsible representatives of non-resident aliens in connection with any sources of income which such non-resident aliens may have within the United States must make a return of such income, and must pay any and all tax, normal and additional, assessed upon the income received by them in behalf of their non-resident alien principals, in all cases where

[73] Reg. 45, Art. 315.

[74] Telegram from Treasury Department dated January 25, 1917; I. T. S. 1918, ¶ 91.

[75] Reg. 45, Art. 403.

[76] Telegram from Treasury Department dated January 25, 1917; I. T. S. 1918, ¶ 91.

[77] Revenue Act of 1918, § 223.

the tax on income so in their receipt, custody or control shall not have been withheld at the source. The agent of a non-resident alien is responsible for a correct return of all income accruing to his principal within the purview of the agency. The agency appointment will determine how completely the agent is substituted for the principal for tax purposes.[78] Any individual, partnership or corporation having the control of, receipt, custody, disposal or payment of fixed or determinable income payable to any non-resident alien, such income with certain exceptions, being required to be withheld at the source, makes a return thereof on or before March 1st of each year and pays the tax due thereon on or before June 15th.[79]

WHERE FILED. A non-resident alien files his return in the district in which he has his principal place of business in this country, and if he has none, then with the Collector of Internal Revenue at Baltimore, Maryland.[80]

WHEN FILED. The return of a non-resident alien should be filed on or before March 15th or on or before the 15th day of the third month following the close of such non-resident's fiscal year accordingly as he reports for income tax purposes on the basis of the calendar or a fiscal year.[81]

EXTENSION OF TIME. Non-resident aliens are allowed a reasonable extension of time for filing returns whenever in the judgment of the Commissioner good cause exists for such extension.[82]

FAILURE TO FILE RETURN. In general, non-resident aliens are subject to the same penalties for failure to file returns as are citizens and residents.[83] In case of failure to file a return the collector will collect the tax on the

[78] Reg. 45, Art. 403.

[79] Revenue Act of 1918, § 221. See Chapter 40 on Collection of the Tax at the Source, and Chapter 6 on Resident Agents.

[80] Revenue Act of 1918, § 227 (b).

[81] Revenue Act of 1918, § 227 (a).

[82] Revenue Act of 1918, § 227 (a). See Chapter 34 on Returns.

[83] See Chapter 36 on Penalties.

income of a non-resident alien and all property belonging to such non-resident alien will be liable to distraint for the tax.[84]

Paying the Tax. Except in so far as the income tax payable by a non-resident alien is collected at the source,[85] the general provisions in regard to the payment of income taxes apply to non-resident aliens as well as citizens and residents. The tax is payable in four installments, the first installment being paid at the time the return is filed; the second installment on the 15th day of the third month; the third installment on the 15th day of the sixth month; and the fourth installment on the 15th day of the ninth month, after filing the return. Where an extension of time for filing a return is granted, the time for payment of the first installment is postponed until the expiration of the period of the extension but the time for payment of the other installments is not postponed unless the Commissioner so provides in granting the extension. In any case in which the time for payment of any installment is at the request of the taxpayer thus postponed, interest at the rate of one-half of 1% per month (6% per year) is added as part of the first installment from the time when it was originally due, unless the whole amount of the tax is paid on or before the time the third installment would have been due if no extension had been granted. If any installment is not paid when due, the whole amount of the tax unpaid becomes due and payable upon notice and demand by the collector. The tax may at the option of a non-resident alien be paid in a single payment instead of installments.[86] This subject is discussed more fully in another chapter.[87]

Abatement and Refund. If upon the filing of the annual return it appears that the non-resident alien is liable for less tax than the amount which has been withheld at the

[84] Revenue Act of 1918, § 217.

[85] See Chapter 40 on Collection of Tax at the Source.

[86] Revenue Act of 1918, § 250.

[87] See Chapter 35 on Assessment and Payment of the Tax.

source, the Treasury Department will issue instructions to the withholding agents (whose names and addresses should be given by the non-resident alien in his return) to release at once the proper amounts.[88] After the tax has been assessed against the withholding agents by the Government, abatement may be claimed, and after the tax has been paid, refund may be claimed in the manner outlined in a later chapter.[89]

[88] Revenue Act of 1918, § 221 (d); Reg. 45, Art. 369. Telegram from Treasury Department dated January 25, 1917; I. T. S. 1918, ¶ 91.

[89] See Chapter 38 on Abatement and Refund.

CHAPTER 6

RESIDENT AGENTS FOR NON-RESIDENT ALIENS, FOREIGN CORPORATIONS AND FOREIGN PARTNERSHIPS

The 1916 Law expressly provided for the collection at the source of the tax on payment of certain specified forms of income to non-resident aliens and non-resident foreign corporations. The persons required to withhold and account for the tax were designated in the regulations as withholding agents.[1] The Treasury Department, in addition, evolved a method of collecting the tax on income which might pass out of its jurisdiction, by impressing upon residents, under certain circumstances, the duty of filing returns and accounting for the normal tax and the surtax on any and all income of non-resident aliens and non-resident foreign corporations over which they had custody or control.[2] Such persons were held to be agents of the non-residents and to stand in the place of their principals.[3] One who was a withholding agent under the provisions for collecting the tax at the source might, or might not, (depending on the circumstances) also be an agent within the meaning of this chapter. Agents for foreign partnerships were not required to make any returns or pay any tax for the foreign partnership unless and until they were so instructed by the Commissioner.[4]

1 See Chapter 40 on Collection of the Tax at the Source.

2 The Department evidently based its authority for this on Revenue Act of 1916, § 9 (g), which provided that the tax should be paid by the owner of the income "or the proper representative having the receipt, custody, control or disposal of the same." T. D. 2452.

3 T. D. 2135.

4 T. D. 2401. This was because a partnership was not itself subject to a tax or required to make returns. See Chapter 11 on Foreign Partnerships.

Ruling Under 1918 Law. The responsible representatives of non-resident aliens in connection with any sources of income which such non-resident aliens may have within the United States shall make a return of such income, and shall pay any and all tax, normal and additional, assessed upon the income received by them in behalf of their non-resident alien principals, in all cases where the tax on income so in their receipt, custody or control shall not have been withheld at the source. The agent of a non-resident alien is responsible for a correct return of all income accruing to his principal within the purview of the agency. The agency appointment will determine how completely the agent is substituted for the principal for tax purposes.[5]

Application of Former Rulings to Present Law. The Revenue Act of 1918 does not contain any provision expressly making an agent liable for the surtaxes imposed upon his principal with respect to income passing through the hands of such agent. The 1916 Law expressly provided[6] that: "The intent and purpose of this title is that all gains, profits, and income of a taxable class, as defined by this title, shall be charged and assessed with the corresponding tax, normal and additional prescribed by this title, and said tax shall be paid by the owner of such income, or the proper representative having the receipt, custody, control, or disposal of the same." The rulings under the 1916 Law are stated below without attempting to indicate to what extent they may be inapplicable to the present law.

DEFINITION. In order to simplify the discussion in the following pages of this chapter the term "non-residents" will be used to include non-resident aliens, foreign corporations having no office or place of business in this country, and foreign partnerships having no office or place of business in this country.[7]

5 Reg. 45, Art. 403.

6 Revenue Act of 1916, § 9 (g).

7 For definition of "foreign corporations" as used in this book

WHO WERE RESIDENT AGENTS. A resident corporation, partnership or individual, might be an agent within the meaning of this chapter. Any residents acting by power of attorney for non-residents were such agents. Responsible heads or representatives who were in charge of property owned or business carried on by non-residents in this country were such agents.[8] Resident nominal stockholders who held stock in their names for non-resident actual owners were such agents.[9] Residents who had custody of securities of non-residents, on which they collected the income, were agents not only with respect to the income, but also with respect to any profits made from the sale of the securities of which they were custodians, and for the purpose of reporting the latter they were required to obtain all facts necessary to ascertain the profit in any transaction.[10] Residents, purchasing patent rights from non-residents and paying royalty thereon, were held to be agents.[11] Real-estate agents who managed buildings owned by non-residents were such agents.[12]

WHO WERE NOT SUCH AGENTS. Corporations paying interest on their own bonds, or dividends on their own stock, to non-residents, bondholders or stockholders, were not held to be agents within the meaning of this chapter, although they were withholding agents for the purpose of collection at the source. Resident debtors, individual or partnership were not held to be agents, but were required to withhold the tax at the source on interest paid to non-resident aliens. Banks were not agents for their non-resident depositors, where the relation was merely that of bank

see Chapter 14. For definition of "foreign partnership" as used in this book see Chapter 11.

8 Reg. 33, Art. 8; T. D. 2313.

9 See Chapter 7 on Nominal Stockholders.

10 Letter from Treasury Department dated May 31, 1916; I. T. S. 1918, ¶ 105.

11 T. D. 2137.

12 Letter from Treasury Department dated January 19, 1915; I. T. S. 1918, ¶ 99.

and depositor[13] and the same has been held where a bank received interest and dividends direct from domestic corporations to be credited to the accounts of non-resident depositors.[14] A bank holding, for account of foreign banks and bankers, securities on which it collected interest and disbursed the same to the foreign banks and bankers, was not held to be an agent,[15] but where a bank acted as custodian of securities for non-residents other than banks, the rule seemed to be that it was an agent.[16] An individual, partnership or corporation occupying or standing in the ordinary relation of broker toward a non-resident as client was held not to be an agent within the meaning of this chapter, but was required to withhold the tax as a withholding agent. In the hypothetical case upon which this ruling was based, the non-resident client maintained an account with the broker, occasionally buying some securities on margin and selling some from time to time, interest being charged on balances due and dividends as paid on the stocks carried and credited to the account. All dealings were in response to directions from the non-resident.[17]

Duties and Liabilities of Resident Agents. The responsible heads or representatives of non-resident aliens in connection with any sources of net income which said non-resident aliens might have within the United States, were required to make a full and complete return of such income and to pay any and all tax, normal and additional, assessed upon the income received by them in behalf of their non-resident alien principals, in all cases where the income tax on income so in their receipt, custody, or con-

13 Banks were not held to be withholding agents with respect to interest paid on deposits. Reg. 33, Art. 67.

14 Letter from Treasury Department dated February 8, 1917; I. T. S. 1918, ¶ 106.

15 Letter from Treasury Department dated April 10, 1916; I. T. S. 1918, ¶ 200.

16 The rulings were not clear or consistent on this point, but it seems that the rulings bore out the conclusions in the text.

17 Letter from Treasury Department dated April 17, 1918; I. T. S. 1918, ¶ 3323.

trol was not withheld at the source.[18] They were under no duty to inquire into or report any income of the non-resident principal received from other sources in this country, but could, if authorized by the non-resident principal, make a complete return of all income from this country. Where the same non-resident had several agents, none of whom was authorized and enabled to make a return of all the principal's income, each agent reported separately the income coming into his hands, and the Treasury Department took into consideration the aggregate amount of net income, covered by all of the returns, in assessing the tax, giving credit for the amount assessed on each return, and making a further assessment to cover the surtax which might be due on the aggregate income in the case of individuals.[19] Of course, if the non-resident principal filed a return of all of his income from sources within this country, the agents were not also required to file returns. Resident agents, therefore, ascertained in due time what their non-resident principals intended to do as to reporting and paying the tax, and governed themselves accordingly.

PROCEDURE IN COLLECTING INCOME FOR NON-RESIDENTS. In collecting income subject to withholding of the tax at the source, the resident agent was required to execute the ownership certificate required of his non-resident principal, signing it with the name of the principal and affixing his own signature as agent.[20] In brief, with respect to such income, he was required to proceed as was required of the non-resident principal, in whose place he stood for the purpose of the income tax. The fact that the non-resident had an agent here did not relieve his income from withholding at the source when paid to such agent.

MAKING RETURNS FOR NON-RESIDENT PRINCIPAL. The agent of a non-resident alien was responsible for a correct return of all income accruing to his principal within the

18 Reg. 33 Rev., Art. 32.

19 Letter from Treasury Department dated March 6, 1917; I. T. S. 1918, ¶ 114.

20 See Chapter 40 on Collection at the Source.

purview of the agency, and the agent was held responsible for a complete return of all such income. The agency appointment determined how completely the agent was substituted for the principal for income tax purposes.[21] In making the annual return for his non-resident principal the resident agent was required to use the same form as would be used by the principal [22] and follow the provisions of the law and the regulations relating to non-resident aliens or foreign corporations, as the case might be, in claiming deductions. The same forms were used for residents and non-residents alike, and, when used by or for a non-resident alien, required certain changes in wording, such as a statement at the beginning that the return covered only income from sources within the United States. In the affidavit at the end of the individual's form, to be executed by the agent, a statement was required to be made that the return covered only the income received by the agent, or that it covered all of the income of the principal from sources within the United States, as the case might be. The affidavit on the corporation's form was prepared for execution by two officers of the corporation. When the return was signed by an agent for a foreign corporation, an affidavit that he was the properly authorized agent, and that the report covered income from all sources within the United States, or income passing through his hands, as the case might be, was required to be attached to the return and duly executed. The return might be filed in the district in which the agent resided or had his principal place of business.

Paying the Tax for Non-Resident Principal. After filing the return, the agent in due course received a notice of assessment showing the amount of tax assessed on the income reported.[23] The tax became due and payable at

[21] Reg. 33 Rev., Art. 32.

[22] Form 1040, in the case of Individuals; Form 1030 or 1030A, in the case of insurance companies, and Form 1031, in the case of other corporations.

[23] A special ruling was made to cover cases in 1916, where the

the same time and in the same manner as the tax assessed on the income of a resident, and could be paid in the same way.[24] Upon paying the tax, the agent could demand a separate receipt for the amount paid on behalf of his non-resident principal, and such receipt was sufficient evidence to justify the agent in withholding the amount therein expressed from his next payment to the principal, if he had not already withheld a sufficient amount to satisfy the tax. The principal could demand this receipt from the agent upon giving him a full written receipt acknowledging the payment of the tax as a satisfaction of the agent's debt to that extent.[25]

ABATEMENT AND REFUND. Taxes improperly or illegally assessed or collected might be abated or refunded in the manner indicated in the chapter dealing with that subject.[26]

agent for a non-resident alien had received income from corporate interest or dividends and paid the same over to his principal prior to September 8. In such cases, if the agent did not have, between September 8 and the end of the year, any income of the non-resident alien from which to pay the tax he was relieved from liability, leaving the tax a charge against the non-resident alien to be collected direct from him by the Treasury Department. (T. D. 2402.) A like special ruling was made to cover cases in 1917 where the agent for a non-resident alien had received income and paid the same over to his principal prior to October 3d. In such cases if the agent did not have, between October 3d and the end of the year, any income of the non-resident alien from which to pay the tax, he was relieved from liability, leaving the tax a charge against the non-resident alien to be collected from him by any means at the disposal of the Commissioner of Internal Revenue; but where the agent received the income of his principal subsequent to October 3d he was obliged to pay the total tax due for the entire year 1917 and subsequent years. (Reg. 33 Rev., Art. 32.)

24 See Chapter 35 on Assessment and Payment of the Tax.

25 Revenue Act of 1916, § 17.

26 See Chapter 38 on Refund and Abatement.

CHAPTER 7

NOMINAL STOCKHOLDERS

For convenience in handling financial transactions, stock certificates are sometimes issued in the names of others than the actual owners of the stock. The individuals, partnerships or corporations so holding the nominal title to the stock are known as nominal stockholders or stockholders of record.[1] A nominal stockholder is not necessarily an agent for the actual owner, but if the actual owner is a non-resident alien individual, a resident nominal stockholder may be an agent in the sense in which that term is used in the preceding chapter.[2] A nominal stockholder is not a withholding agent, although under the 1916 Law he might have been one if the actual owner was a non-resident foreign corporation. The distinction between a nominal stockholder and a fiduciary lies in the fact that the latter holds legal title to stock (if that is the subject of the trust), while a nominal stockholder may hold no title at all, the stock merely standing in his name on the books of the corporation. Nominal stockholders may acquire their status by arrangement with the actual owners, as where a broker carries in his name the stock of a customer, in which event the name and status of the actual owner is known; but in some cases the names of the actual owners may not be known to the nominal stockholder as, for instance, where the actual ownership is evidenced by bearer certificates, and the procedure under the 1916 Law applicable to such situations is indicated at the end of this

1 They are generally called "owners of record" in the regulations.
2 Reg. 33 Rev., Arts. 32 and 201.

chapter. In other cases, notably when large amounts of stock are left in the names of stock exchange houses, one may become a nominal stockholder without knowing the identity of the actual owner. Thus, stock certificates endorsed in blank by an actual owner, and sold on the market, may pass by delivery to several consecutive purchasers before the stock is transferred on the books of the corporation. In such cases, the original transferor remains the record owner until the transfer is made on the corporate books, and, as such, he is presumed to be the real owner of dividends declared on the stock, unless he proves that actual ownership of the stock does not rest in him.[3] If, however, a nominal stockholder not only parts with the certificate of stock, endorsed in blank, but also gives the corporation a "dividend order" to pay dividends to another, his responsibility for tax on such dividends ceases, and the one to whom the corporation pays the dividend becomes liable for any tax thereon, unless he in turn shows that actual ownership does not rest in him. A nominal stockholder receiving dividends and paying them over to one claiming to be the actual owner, was required under the 1916 Law to ascertain the name and address of such claimant and proceed as indicated below.[4]

Application of Present Law to This Chapter. The Treasury Department based its authority for the rules and regulations discussed in this chapter in regard to withholding on dividend income against non-resident foreign corporations on the basis of apparent ownership, upon the provision[5] of the 1916 Law that "all the provisions of this title relating to the tax authorized and required to be deducted and withheld and paid to the officer of the United States Government authorized to receive the same from the

[3] Letter from Treasury Department dated Dec. 28, 1916; I. T. S. 1918, ¶ 274.

[4] The regulations on this subject refer only to dividends on domestic corporations and resident foreign corporations. (Reg. 33 Rev., Arts. 32, 200, 201; T. D. 2374, 2386, 2388, 2401 and 2402.)

[5] Revenue Act of 1916, § 13 (f).

income of non-resident alien individuals from sources within the United States shall be made applicable to income derived from dividends upon the capital stock or from the net earnings of domestic or other resident corporations, joint-stock companies or associations, and insurance companies by non-resident alien companies, corporations, joint-stock companies, or associations, and insurance companies not engaged in business or trade within the United States and not having any office or place of business therein." This provision was separate from and additional to the general withholding provision [6] of the 1916 Law which expressly excepted from its scope "income derived from dividends on capital stock, or from the net earnings of a corporation, joint-stock company or association, or insurance company, which is taxable upon its net income as provided in this title." The Treasury Department based its authority for requiring the tax to be paid on dividend income of non-resident alien individuals, by nominal stockholders or record owners upon the provision [7] of the 1916 Law that "the intent and purpose of this title is that all gains, profits, and income of a taxable class, as defined by this title, shall be charged and assessed with the corresponding tax, normal and additional, prescribed by this title, and said tax shall be paid by the owner of such income, or the proper representative having the receipt, custody, control, or disposal of the same." The general withholding provision [8] of the Revenue Act of 1918 expressly excepts from its scope "income received as dividends from a corporation which is taxable under this title on its net income," and contains no provision corresponding to the provision of the 1916 Law quoted above applying its general withholding requirements to income derived from dividends received by non-resident foreign corporations or making an agent liable for the surtaxes imposed upon his principal with respect to income passing through the hands of such agent. The reason for the

[6] Revenue Act of 1916, § 9 (b).
[7] Revenue Act of 1916, § 9 (g).
[8] Revenue Act of 1918, §§ 221 and 237.

failure of the present law to provide for withholding against non-resident foreign corporations as to income derived from dividends is that foreign corporations, as well as domestic corporations, are now entitled to deduct from gross income, in computing net income "amounts received as dividends from a corporation which is taxable upon its net income, and amounts received as dividends from a personal-service corporation out of earnings or profits upon which income tax has been imposed by act of Congress."[9] Under the present law no withholding from corporate dividends is required in any case,[10] but the Treasury Department holds that the responsible representatives of non-resident aliens in connection with any sources of income which such non-resident aliens may have within the United States shall make a return of such income, and shall pay any and all tax, normal and additional, assessed upon the income received by them in behalf of their non-resident alien principals, in all cases where the tax on income so in their receipt, custody or control, shall not have been withheld at the source. The agent of a non-resident alien is responsible for a correct return of all income accruing to his principal within the purview of the agency. The agency appointment will determine how completely the agent is substituted for the principal for tax purposes.[11] Dividends on stock of domestic corporations or resident alien corporations are *prima facie* income of the record owner of the stock, and such record owner will be liable for any additional tax based thereon, unless a disclosure of the actual ownership is made to the Commissioner, which shall show that the record owner is not the actual owner and who the owner is and his address. In all cases where the actual owner is a non-resident alien individual and the record owner is a person in the United States, the record owner will be considered for tax purposes to have the receipt, custody, control and disposal of the dividend income and

9 Revenue Act of 1918, § 234 (a) 6 and (b).
10 Reg. 45, Art. 362.
11 Reg. 45, Art. 403.

will be required to make return for the actual owner, regardless of the amount of the income, and to pay any surtax found by such return to be due.[12] The rulings under the 1916 Law are stated below.

PROCEDURE WHEN NOMINAL STOCKHOLDER WAS A RESIDENT AND ACTUAL OWNER WAS A RESIDENT. In cases where both the nominal stockholder and the actual owner were residents of the United States, the nominal stockholder was not required to obtain any certificate disclosing the name of the actual owner. The primary purpose of requiring disclosure of the actual owner was to assist in administering that provision of the 1916 Law, which made dividends on the stock of domestic corporations or resident foreign corporations taxable when paid to non-resident aliens and required withholding when paid to non-resident foreign corporations.[13] The actual owner was, of course, in all cases under duty of reporting the dividends and paying the taxes thereon, if he was liable; the nominal stockholder was under no duty to report the dividends as his income but should be prepared to show conclusively, if question arose, that the actual ownership did not rest in him.[14] If a nominal stockholder paid over the dividends to a resident whom he knew to be the agent of a non-resident alien, he was under no duty as agent, since it was the one who collected the dividend for a non-resident, or who finally paid it over to a non-resident, who had impressed upon him the duty of agent within the meaning of the preceding chapter.

PROCEDURE WHEN NOMINAL STOCKHOLDER WAS RESIDENT AND ACTUAL OWNER WAS NON-RESIDENT. In cases where the nominal stockholder was a resident, and the actual owner was a non-resident alien individual partnership or

[12] Reg. 45, Art. 404. Disclosure is made on Form No. 1087 (revised).

[13] Letter from Treasury Department dated Nov. 21, 1916; I. T. S. 1918, ¶ 272.

[14] Letter from Treasury Department dated Nov. 21, 1916; I. T. S. 1918, ¶ 272.

corporation, the nominal stockholder might make disclosure of the actual owner by filing a certificate of actual ownership.[15] This certificate was obtained by the nominal stockholder from the actual owner and showed who the actual owner was, his address, and that the nominal stockholder was not the actual owner. It was to be forwarded by the nominal stockholder to the Collector, by attaching it to the return of income which he was required to file for the actual owner,[16] and was to be filed even if the amount of income was so small that no annual return was required, as proof of the fact that the nominal stockholder was not the actual owner of the stock. A certificate of ownership once filed was sufficient until the ownership changed, in which case it was necessary to disclose the new actual owner, as in the first instance.[17] If the above disclosure was made, the nominal stockholder was held for income-tax purposes to have the receipt, custody, control and disposal of the dividend income and was required to make return for the actual owner and pay the tax found by such return to be due. When the actual owner was a non-resident *foreign corporation* return [18] was made, regardless of the amount of income and the normal tax paid. When the actual owner was a non-resident alien *individual,* a return [19] was made regardless of the amount of income and the surtax was paid thereon when it exceeded $5,000. When the actual owner was a non-resident foreign *partnership,* the certificate of disclosure was transmitted to the Commissioner for the

[15] Reg. 33 Rev., Art. 32. This article of Reg. 33 Rev. and also Art. 201, deal generally with the subject of this chapter. See also letter from Treasury Department dated June 6, 1918; I. T. S. 1918, ¶ 3528. Form No. 1087 was used for this purpose.

[16] T. D. 2401.

[17] T. D. 2401.

[18] Form 1031.

[19] Form 1040-B, modified to indicate that the return covered only income passing through hands of the nominal stockholder and did not purport to be a complete statement of income on behalf of the actual owner.

information of the Collector, but no return [20] was required to be made for such partnership and no amount was required to be retained by the representative of such partnership in the United States unless and until such representative was so instructed by the Commissioner.[21] If the above disclosure was not made, dividends on the stock of domestic or resident foreign corporations were held *prima facie* to be income to the nominal stockholder and he was liable to the normal tax or surtax according to his or its individual or corporate status.[22]

PROCEDURE WHEN NOMINAL STOCKHOLDER WAS NON-RESIDENT AND ACTUAL OWNER WAS RESIDENT. In cases where the nominal stockholder was a non-resident individual, partnership, or corporation and the actual owner was a resident, the nominal stockholder might make disclosure of the actual owner by filing a certificate of actual ownership.[23] This certificate showed who the actual owner was, his address, and that the nominal stockholder was not the actual owner.[24] Certificates of nominal stockholders who were non-resident alien individuals or partnerships were filed with the Collector at Baltimore, Maryland, and were attached to the nominal stockholder's annual return of net income, if such a return was filed. When the actual ownership was thus disclosed, the Commissioner made such assessments and issued such instructions to debtors and withholding agents as insured the proper collection of the tax, in accordance with respective tax liabilities. The certificate of a nominal stockholder, which was a non-resident foreign corporation, might be filed with the domestic or resident foreign corporation paying the dividend, or its paying

[20] A return might be executed for a partnership on Form 1040-B.

[21] Reg. 33 Rev., Art. 32.

[22] Reg. 33 Rev., Art. 32.

[23] The form to be used was Form 1087, striking out the words "to be filed with representative in the United States of such foreign principal," in the caption, and the words "in the United States" in the body of the form, and executing the certificate as the representative of the actual owner in the space provided for signature.

[24] Note Reg. 33 Rev., Art. 32.

agent in the United States, and upon the filing thereof would be accepted by the corporation paying the dividend as evidence that the nominal stockholder was not liable for income tax on the dividend to be paid, and such paying corporation would be governed by the established facts in not withholding the tax on such dividends.[25] In the absence of disclosure of actual ownership filed with the corporation paying the dividend or its withholding agent, such corporation or its withholding agent would be held liable on their stock records of ownership for the tax required to be withheld, and would withhold the normal tax and pay the same to the proper officer of the United States authorized to receive it in the manner and form provided for withholding and accounting for tax withheld.[26] In such cases it was the duty of the paying corporation to make monthly return of such withholding.[27] An annual return, which was a summary of such monthly returns, was filed on or before March first of each year for the preceding calendar year.[28] The tax so paid and deducted from the dividend paid could only be released to a nominal stockholder not liable therefor upon a proper showing to the Commissioner of record and actual ownership and names and post office addresses of debtor corporations and withholding agents and the amounts withheld.[29] If, for any reason, there was included in the return of a non-resident foreign corporation of income from sources within the United States dividends upon which tax had been so withheld at the source, such non-resident foreign corporation might take credit against the amount of tax due for the amount of tax so withheld at the source, provided a statement was attached to the return setting forth the source and amount

[25] Reg. 33 Rev., Art. 32.
[26] Reg. 33 Rev., Arts. 32 and 201.
[27] This return was made on Monthly Form 1012.
[28] Reg. 33 Rev., Art. 201.
[29] Reg. 33 Rev., Art. 32.

of the income upon which the tax had been so withheld.[30] There was no duty on the part of a non-resident nominal stockholder to file any return or account for any tax on behalf of the actual owner. That duty was imposed only when the nominal stockholder was a resident of this country.[31] A foreign partnership, although itself not subject to tax, filed a certificate of ownership, as indicated above, in order to release its individual members from the tax liability which would otherwise have attached by reason of apparent ownership upon the distributive shares of the partnership profits.

PROCEDURE IN CASE OF DUTCH ADMINISTRATION OFFICES. A special ruling has been made with respect to the so-called "Administration Offices" in Holland, which has application to many similar situations in foreign countries. It appears that the Dutch Administration offices are the registered owners of large blocks of American stocks, against which they have issued bearer certificates, with coupons attached. These coupons, upon presentation and surrender, entitle the bearer to dividends declared on the stock. The Administration Offices were held to be *prima facie* liable for the tax on dividends paid on the stock standing in their names, unless they disclosed the names of the actual owners by use of the proper certificates.[32] By appointing an agent in the United States they could avoid having the tax withheld at the source. Such agent was required to make returns of income for the Dutch Administration Office represented by him and pay the corporation tax of 2% on all dividends received by it, except such amounts as were shown by certificates disclosing actual ownership to have been received for the account of non-resident alien individuals or partnerships. Such certificates were attached to and made the basis of the return when filed.[33]

30 Reg. 33 Rev., Art. 201.
31 See Note 15 of Text.
32 Form 1087.
33 T. D. 2386, T. D. 2669. This ruling was based on the theory that

Certificates Issued to Bearer. When stock of an American corporation is floated in some European countries, where investors are accustomed to bearer stock certificates, a block of the stock is sometimes issued to a trust company in this country which in turn issues bearer certificates entitling the holder to certificates of stock for the number of shares designated, upon the surrender of bearer certificate, and to any dividends which may be declared on such shares while the bearer certificate is outstanding. The bearer certificates pass by delivery, the dividends being claimed through foreign banks by presentation and surrender of numbered coupons attached thereto. In such cases the trust company was, under the 1916 Law, in the position of a resident nominal stockholder.

Dutch Administration offices were "non-resident alien corporations," subject to tax on dividends and to having the tax withheld at the source. Since the present law does not tax corporations on dividends received by them it seems, only on some other theory can they be required to ascertain and disclose the names of the owners of their bearer certificates, under the present law.

CHAPTER 8

FIDUCIARIES

The Revenue Act of 1918 provides that every fiduciary (except receivers appointed by authority of law in possession of part only of the property of an individual) shall make, under oath, a return for the individual, trust or estate for which he acts, as outlined in this chapter.[1] For the purpose of discussion in this book fiduciaries are divided into two classes, this chapter dealing with the subject in general and with the particular provisions applicable to domestic fiduciaries, that is, those which reside in this country or have an office or place of business here and consequently are within the jurisdiction of this Government. Foreign fiduciaries, which subject is treated in the following chapter, are defined for the purpose of this book as fiduciaries who neither reside in this country nor have an office or place of business here, that is, those who are not within the jurisdiction of this Government. A non-resident citizen acting as a fiduciary would, it seems, be entitled to be classed with the domestic fiduciaries, since the United States has some measure of jurisdiction over him as a citizen, and since the withholding provisions of the law do not apply to non-resident citizens.

Who Are Fiduciaries. The Revenue Act of 1918 defines the term "fiduciary" to mean a "guardian, trustee, executor, administrator, receiver, conservator, or any *person* acting in a fiduciary capacity for any person, trust or estate."[2] In view of the definition of the word "person"

1 Revenue Act of 1918, § 225.
2 Revenue Act of 1918, § 200.

used in the above definition,[3] a corporation, partnership, joint-stock company or insurance company may be a fiduciary under the law. Some rulings and regulations issued under the 1916 and former laws in explanation of the term "fiduciary" are given below as indicative of the Treasury Department's attitude in interpretation of the broad term "any person acting in any fiduciary capacity for any person, trust or estate." Thus, it has been held that a fiduciary for income tax purposes is one who holds in trust an estate to which another has the beneficial title or in which another has a beneficial interest,[4] or receives and controls the income of another, as in the case of receivers. It has also been ruled that the term "fiduciary" applies to all persons or corporations who occupy positions of peculiar confidence towards others, such as trustees, executors, or administrators, and that a fiduciary for income tax purposes is any person or corporation who holds in trust an estate to which another has a beneficial interest or receives and controls income of another as in the case of minors.[5]

AGENTS. An agent, as such, is not a fiduciary for his principal even though he may have complete charge of the property of his principal.[6] There may be a fiduciary relationship between an agent and a principal, but the word "agent" does not denote a fiduciary within the meaning of the law.[7]

POWER OF ATTORNEY. A person cannot, by power of attorney, appoint another to act as a fiduciary. A power of attorney can not create a fiduciary relationship. An agent having entire charge of property with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, paying

[3] In Revenue Act of 1918, § 1, the term "person" is defined to include "partnerships and corporations as well as individuals." The term "corporation" includes associations, joint-stock companies and insurance companies.

[4] T. D. 2090.

[5] Reg. 45, Art. 1521; Reg. 33 Rev., Art. 29.

[6] T. D. 2135.

[7] Reg. 33 Rev., Art. 29; T. D. 2090.

taxes and expenses and all other charges in connection with the property out of funds in his hands from collection of rents, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by power of attorney, is not a fiduciary within the meaning of the income-tax law. In all cases, where no legal trust has been created in the estate controlled by the agent and attorney, the liability under the law to make returns and pay the taxes rests with the principal.[8]

GUARDIANS. A legal guardian is a fiduciary, but it does not seem that a natural guardian comes within the definition. It was held by the Treasury Department under the 1916 Law that where a minor child was in receipt of income, the father, his natural guardian, could not make a return covering the income of the child, but should include the income of the minor as a part of his (the father's) income for the year.[9] The income of a minor child could be reported separately only where it was from a separate legal estate and the parent had been appointed guardian and the conditions were such that the income was to be held for the use of the child.[10] Under the Revenue Act of 1918, minors are required to file returns, and it seems that if a minor exercises independent control of any of his own income, the guardian should not make a separate return for the minor of income from a separate estate nor should the parent include the minor's income in his own return.

ANCILLARY ADMINISTRATOR. An ancillary administrator is held to be merely an agent of the domiciliary administrator and should transmit to him all information as to income of the estate received by the ancillary administrator, to the end that the original administrator may make a return covering the entire income of the estate.[11]

8 Reg. 45, Art. 1522; Reg. 33 Rev., Art. 29; T. D. 2137.

9 Reg. 33 Rev., Art. 29. Letter from Treasury Department dated October 30, 1916; I. T. S. 1918, ¶ 378.

10 Reg. 33 Rev., Art. 29.

11 Reg. 33 Rev., Art. 180.

RECEIVERS. A receiver for an individual is a fiduciary, but it seems that a receiver for a corporation is not [12] notwithstanding the broad definition of the words "fiduciary" and "person," and the general provisions governing fiduciaries in section 225 of the law. It is specifically provided elsewhere that receivers, trustees in bankruptcy, or assignees operating the property or business of corporations shall make returns for such corporations in the same manner and form as corporations are required to make returns and that any tax due on the basis of such returns will be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.[13] It is also specifically provided that receivers appointed by authority of law, in possession of part only of the property of an individual, are also expressly excepted from the requirements that fiduciaries make returns.[14]

TEMPORARY RECEIVER HELD TO BE FIDUCIARY. Under the 1916 Law it was held that one appointed under interlocutory orders of the United States District Court to act as receiver of an individual in a proceeding wherein certain persons complaining as creditors were seeking to have the property of the individual distributed among them, was held to be a fiduciary, notwithstanding that title to the property in question (cash and securities) remained in the individual sued and that his position and right to deal with the same were only suspended. The receiver having received income from the property in his possession was required to file a return as a fiduciary.[15]

MORTGAGE FORECLOSURE RECEIVERS. It was first held by the Treasury Department under the 1916 Law that a receiver in foreclosure proceedings of the rents, issues and

12 Reg. 45, Art. 424. See letter from Treasury Department dated February 27, 1915; I. T. S. 1917, ¶ 597, and letter from Treasury Department dated June 22, 1916; I. T. S. 1918, ¶ 1087.

13 Revenue Act of 1918, § 239.

14 Revenue Act of 1918, § 225.

15 Letter from Treasury Department dated January 22, 1917.

profits of mortgaged premises, even though for only a part of the property of the mortgagor, was required to file a return of income reporting the entire operations transacted by the receiver during the year 1917.[16] Upon further consideration the Treasury Department changed this ruling. It appeared that the receiver, who was appointed in a mortgage foreclosure action in the State of New York, was appointed by a court of equity in aid of its jurisdiction and was not a receiver of all the property of the mortgagor corporation, but was a common law receiver in charge of only a part of the mortgaged property of the corporation and was a receiver merely of the rents and profits of such mortgaged property. The Treasury Department, therefore, held that although such receiver was required to file a return of information at the source, he need not file a return of income, as required by its previous ruling. This is the rule under the present law.[17]

COMMITTEE FOR AN INCOMPETENT. The committee for the property of an incompetent person is regarded as a fiduciary.[18]

DEEDS OF TRUST. A deed of trust must be absolute so far as the conveyance of title is concerned and irrevocable by the donor, otherwise the income from the property in question will accrue to the donor and must be accounted for by him.[19]

Who Are Beneficiaries. A beneficiary within the meaning of the law and regulations and in the sense used in this book is the ward, *cestui que trust*, legatee, distributee, creditor, or other person entitled to any part of net income

16 Letter from Treasury Department dated March 28, 1918; I. T. S. 1918, ¶ 3293.

17 Letter from Treasury Department dated May 1, 1918; I. T. S. 1918, ¶ 3343. This letter stated that the same ruling extended to receivers of partnerships under the excess profits tax. As to rule under present law see Reg. 45, Art. 424.

18 Reg. 45, Art. 1521; Reg. 33 Rev., Art. 29. Letter from Treasury Department dated February 21, 1916; I. T. S. 1918, ¶ 128; letter from Treasury Department dated May 1, 1918; I. T. S. 1918, ¶ 3343.

19 Reg. 33 Rev., Art. 29.

of a trust or estate in the charge of a fiduciary. The trust estate itself is a beneficiary with respect to (1) income received by estates of deceased persons during the period of administration or settlement of the estate and not credited to any other beneficiary; (2) income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests; (3) income held for future disposition under the terms of the will or trust.[20]

Duties of Fiduciaries Generally. Every fiduciary is required by the law to "make under oath a return for the individual, estate or trust for which he acts."[21] The fiduciary is taxed upon the net income of the estate except as to (a) income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and (b) income collected by a guardian or an infant to be held or distributed as the court may direct. and (c) any income of an estate of a deceased person during the period of administration or settlement which is properly paid or credited to any legatee, heir or other beneficiary.[22] Under the 1916 Law fiduciaries were expressly indemnified against the claims or demands of every beneficiary for all payments of taxes which they were required to make under that law and were given credit for the amount of such payments against the beneficiary or principal in any accounting which they made as such fiduciary.[23] No such provision seems to be in the present law.

Receiver. Receivers who, as officers of a court, stand in the stead of some principal are required to account for income tax as the principal would have been required to account.[24] Where a receiver for an individual, acting

[20] See Revenue Act of 1918, § 219.

[21] Revenue Act of 1918, § 225.

[22] Revenue Act of 1918, § 219 (c) and (d).

[23] Revenue Act of 1916, § 2 (b).

[24] Reg. 45, Art. 424; Reg. 33 Rev., Art. 26. Form No. 1040 (revised) or 1040A (revised) is used by a receiver for an individual. The statements contained in the text above in regard to receivers are founded upon rulings and regulations issued under the 1916 Law. This Law contained a general provision (Revenue Act of 1916, § 9

under interlocutory orders of the court, receives income during any year on funds which he holds in trust as such receiver, such income must be accounted for and the tax paid thereon for that year. The income being thus freed of tax liability imposed by statute, it assumes the status of capital and may thereafter be distributed by the receiver in the same manner as other capital. The fact that all or any part of the income received by a receiver may be used to pay creditors does not relieve the receiver from first paying the tax on all income received by him, less the deductions, credits and exemptions allowed by the law—the Government has a prior lien for the amount of the tax; what remains may be distributed to creditors or others.[25]

Executors and Administrators. In addition to the duties of fiduciaries generally, executors and administrators are charged with the duty of making returns of income of the decedent for the period during which he lived for which he made no return prior to his death, as more fully stated in a subsequent paragraph.

Income of Estates and Trusts. The income of estates and trusts received during any taxable year is subject to tax either (a) in the hands of the beneficiaries on their respective shares paid to them or credited to them by the fiduciary during the year or (b) in the hands of the fiduciary if the income is not paid or credited to a beneficiary.

(g)) which charged all gains, profits and income of a taxable class with the corresponding tax, and provided further, that such should be paid by "the owner of such income, or the proper representative having the receipt, custody, control, or disposal of the same." The Revenue Act of 1918 seems to contain no similar provision. However strong the implication may be that receivers are to pay the tax on income of the persons for whom they act, the absence of a mandatory provision imposing this duty and indemnifying them against all claims and demands of every beneficiary for all payments of taxes they are required to make, may place receivers in embarrassing situations, since they are held rigidly to account for all their acts, and any moneys paid out under doubtful authority may involve them in personal liability.

[25] Letter from Treasury Department dated February 9, 1917; I. T. S. 1918, ¶ 741.

In other words all or a part of the net income of an estate or trust may be distributable to beneficiaries and if so there is to be included in computing the net income of each beneficiary his distributive share, whether distributed or not, and in such cases the fiduciary is required to make a return showing the net income of the estate or trust and the distributable shares of each beneficiary. On the other hand, all or a part of the net income of an estate or trust may be retained for future distribution and at the end of the year is added to the corpus of the estate. With respect to such income the estate or trust is taxed to the fiduciary and he is required to file a return showing the amount of such net income and the tax due thereon in the same manner that individuals are required to report and pay tax.[26] If part of the income is distributable and part is retained by the estate, the tax is imposed on the respective parts as above indicated.

Gross Income of Estates and Trusts. The gross income of an estate or trust embraces income from all sources, as in the case of individuals.[27] The corpus of the estate, that is, the amount of capital transferred to the estate at the time of its creation, is not income. Thus in the case of estates of deceased persons, the appraised value of the property at the time of the death of the decedent is capital of the estate, regardless of the fact that the cost of that propery to the decedent may have been less than such appraised value.[28] Similarly the value of the estate at the time a trust is created is the capital of the trust. All income derived from the corpus or capital of an estate or trust is income to such estate or trust. But income received by a decedent before his death is capital when received by the estate. Where during the period of administration an executor converts the estate in his possession into money

[26] Rev. Act of 1918, § 219; Reg. 45, Arts. 341 to 344 incl. and Arts. 421 to 425 incl.

[27] Id. § 219 (a).

[28] Telegram from Treasury Department, dated February 3, 1917; I. T. S. 1918, ¶ 713.

for the purpose of settling the estate and closing the administration the gain or loss on the sale of such property is determined by deducting from the selling price (or vice versa) the appraised value of the property at the death of the decedent or if the estate was created prior to March 1, 1913, the fair market price or value on that date.[29] If the corpus of an estate or trust is delivered in kind to beneficiaries no income is realized by the estate or trust although the value of the property when delivered may be greater than its appraised value at the time of its transfer to the estate or trust.[30] The rules laid down by the courts wth respect to the difference between income and capital in cases between life-tenant and remainderman do not necessarily apply under the provisions of the income tax law, so far as assessing the tax is concerned. Thus, extraordinary dividends received by an estate are held to be income to the same extent as if received by an individual, although a part of the surplus and undivided profits from which such dividend is declared may have been earned by the corporation prior to the creation of the estate.

Proceeds of Life Insurance Policies. The proceeds of life insurance policies paid to the estate upon the death of the insured are exempt from income tax under the present law. Under the 1916 Law and the 1913 Law the proceeds of life insurance policies were exempt only if paid to individual beneficiaries.[31] Under the 1916 Law the proceeds of life insurance policies payable to the estate of decedent, when received by an executor or administrator were, in the amount by which such proceeds exceeded the premium or premiums paid by the decedent, income of the estate to be accounted for by the executor or administrator.[32]

Liberty Bond Exemption in Case of Estates and Trusts. When income is taxable to beneficiaries, as in the case

[29] Id. Reg. 45, Art. 342.
[30] See Reg. 45, Art. 342.
[31] Rev. Act of 1918, § 213 (b) 1; Revenue Act of 1916, § 4.
[32] Reg. 33 Rev., Art. 29.

of a trust the income of which is to be distributed to the beneficiaries periodically, each beneficiary is regarded as the owner of a proportionate part of the bonds held in trust and is entitled to exemption on account of such ownership as if he owned such proportionate part of the bonds directly. In such a case a subscription by a trustee for bonds of the fourth liberty loan constitutes each beneficiary existing at the time of such subscription an original subscriber for his proportionate part of such bonds and entitles such beneficiary to the collateral exemption of interest on bonds of previous issues, whether owned by such beneficiary or by the trustee, as if the beneficiary had himself originally subscribed for such proportionate part of the bonds, and a subscription by such beneficiary for bonds of the fourth liberty loan entitles him to the collateral exemption of interest on bonds of previous issues held by the trustee. When, on the other hand, income is taxable to the trustee, as in the case of a trust the income of which is accumulated for the benefit of unborn or unascertained persons, the trustee is regarded as the owner of all the bonds held in trust and the trust is entitled to any exemption on account of such ownership. In such a case a subscription by a trustee constitutes the trustee as such the original subscriber and entitles the trust, on account of such subscription, to the collateral exemption of interest on bonds of previous issues.[33]

Deductions Allowed to Estates and Trusts. In computing the net income of trust estates the same deductions are allowed as in the case of computing net income of individuals with one exception as indicated in the next following paragraph.[34] The Treasury Department, however, made several special rulings under the 1916 Law with respect to the deductions which may be claimed by fiduciaries against the income of estates or trusts and these rulings are given in the succeeding paragraphs.

[33] Reg. 45, Art. 79.
[34] Rev. Act. of 1918, § 219 (b).

for the purpose of settling the estate and closing the administration the gain or loss on the sale of such property is determined by deducting from the selling price (or vice versa) the appraised value of the property at the death of the decedent or if the estate was created prior to March 1, 1913, the fair market price or value on that date.[29] If the corpus of an estate or trust is delivered in kind to beneficiaries no income is realized by the estate or trust although the value of the property when delivered may be greater than its appraised value at the time of its transfer to the estate or trust.[30] The rules laid down by the courts wth respect to the difference between income and capital in cases between life-tenant and remainderman do not necessarily apply under the provisions of the income tax law, so far as assessing the tax is concerned. Thus, extraordinary dividends received by an estate are held to be income to the same extent as if received by an individual, although a part of the surplus and undivided profits from which such dividend is declared may have been earned by the corporation prior to the creation of the estate.

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[33] Reg. 45, Art. 79.
[34] Rev. Act. of 1918, § 219 (b).

Contributions to Charities. In lieu of the deduction authorized in the case of citizens or residents for charitable contributions, trust estates are allowed to deduct any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid to or permanently set aside for the United States, any state, territory, or any political subdivision thereof, or the District of Columbia, or any corporation organized and operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual.[35]

Business Expenses. The ordinary and necessary expenses carrying on a business which may be conducted by the fiduciary including salaries, wages, rentals, repairs to business properties, etc., have been held to be properly deductible, since they are expenses which reduce the income accruing to the beneficiaries.[36]

Expenses Not Deductible. A distinction has been made between such expenses as are properly chargeable against the corpus of an estate at the time of its creation, and such other expenses incident to administration, as may arise from the nature of the properties and the details of business management. Thus, court costs, attorneys' fees, executors' commissions, etc., have been held generally to be expenses that reduce the corpus of the estate in the administrator's hands and not expenses which directly reduce the income accruing to the beneficiaries. Therefore such expenses have been held not to be a proper deduction from the annual income.[37]

Executors' Commissions. If under the laws of the state or the terms of the will or the decree of a court executors' commissions are deductible from the corpus of the estate they should not be included as deductions in the

35 Revenue Act of 1918, § 219 (b).
36 Revenue Act of 1918, §§ 219 (b) and 214 (a) 1.
37 T. D. 2090, T. D. 2135.

annual return of the fiduciary, but if they are to be deducted from the income of the estate distributable among the beneficiaries the amount should be entered as a legitimate and necessary expense.[38]

INTEREST. Any interest which a trust estate may be required to pay to creditors is a proper deduction, except interest or indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is exempt from the income tax.[39]

TAXES. Any tax paid by a trust estate is a proper deduction to the same extent as in the case of individuals or corporations. Inheritance taxes are held not to be deductible.[40] But interest paid with respect to deferred payments of such taxes is deductible.

LOSSES. Losses sustained during the taxable year, and not compensated for by insurance or otherwise, (a) if incurred in trade or business, (b) if incurred in any transaction entered into for profit, though not connected with the trade or business, or (c) if of property not connected with the trade or business if arising from fires, storms, shipwreck, or other casualty, and from theft, not compensated for by insurance or otherwise, or losses applicable to the preceding taxable year may be deducted under the rules applicable to individuals.[41] In case the estate was created prior to March 1, 1913, a loss sustained by the sale of property is determined by the fair market price or value of the property as of that date. If the estate was created subsequent to March 1, 1913, the loss is determined on the basis of the appraised value of the property at the time the decedent died or the estate was otherwise created.[42]

[38] Letter from Treasury Department dated March 2, 1915; I. T. S. 1918, ¶ 795.

[39] See Chapter 29 on Deduction of Interest.

[40] See Chapter 30 on Deduction of Taxes.

[41] See Chapter 31 on Deduction of Losses.

[42] See Telegram from Treasury Department dated February 3, 1917; I. T. S. 1918, ¶ 713.

Depreciation. The general rules relating to depreciation [43] have been modified in the case of trust estates, by the following ruling of the Treasury Department:

In the case of a trust estate where the terms of the will or trust or the decree of a court of competent jurisdiction or the general law requires the corpus of the estate to be kept intact, and where physical property forming a part of the corpus of such estate is subject to depreciation through its employment in business, the fiduciary may claim in his return of income an allowance for such depreciation for the taxable year, provided the deduction is applied or held by the fiduciary for making good such depreciation. Fiduciaries should set forth in connection with their returns the provisions of law, trust, or decree requiring such depreciation deduction and should show that the amount deducted has been or will be preserved and so applied. All amounts paid by fiduciaries to beneficiaries of trust estates from the income of such trust estates, whether from reserves or otherwise, are held to be distributions of income and will be treated for income tax purposes in accordance with the provisions of law and regulations applicable to income of such beneficiaries.[44] No depreciation deduction will be permitted to fiduciaries other than as above provided. The intent is to deny to fiduciaries the right of claiming a deduction for depreciation if the amount of such deduction is actually paid to the beneficiary as income. This ruling, however, does not deny the trustee the right of making deductions for expenses actually incurred for repairs and such other necessary expenses, other than betterments, as may be required to preserve the corpus of the estate.[45]

Depletion of Natural Resources. If a trust estate has capital invested in mines, oil and gas wells, other natural deposits, and timber, depletion for the exhaustion

[43] See Chapter 32 on Depreciation.
[44] Reg. 45, Art. 164; Reg. 33 Rev., Art. 29.
[45] T. D. 2267.

of the natural deposits may be claimed to the same extent as is permitted to individual owners.[46]

Net Income of Estates or Trusts. The gross income minus the deductions enumerated above is the net income of estates or trusts. The amount of such net income may be distributable to the beneficiaries in accordance with the terms of the will or the conditions of the trust in which event the beneficiaries will report on their personal returns the amounts of their respective distributable shares and the tax will be assessed to them, but if any or all of such income is not so paid or credited to the beneficiaries that part is treated as taxable income of the estate on which the fiduciary must pay a tax from the funds of the estate. When the income upon which the fiduciary has so paid the income tax is later distributed among the beneficiaries it is treated as a distribution of capital and no tax is at that time required to be paid by the beneficiary with respect thereto.[47] For the purpose of the normal tax the same credits may be deducted from the net income as is allowed in the case of individuals.[48] Where a part of the income is distributed among beneficiaries and a part is not the respective credits are divided proportionately between the beneficiaries and the estate. Thus, if one beneficiary receives one-fourth of the net income he will be entitled to one-fourth of the credits and if the undistributed income of the estate on which the fiduciary is taxable amounts to one-tenth of the estate the fiduciary will claims one-tenth of the credits. These credits are as follows:

Credit of Dividends. The amount received as dividends from a corporation which is taxable under the law upon its net income and amounts received as dividends from a personal-service corporation out of earnings or profits upon which the income tax has been imposed by Act of

[46] See Chapter 33.
[47] Reg. 33 Rev., Art. 29; Reg. 45, Art. 343.
[48] Rev. Act of 1918, § 219 (d) and § 216 (a) and (b).

Congress.[49] The amount of such income must be included in the gross income of the estate and is not deducted for the purpose of determining its net income, but is deducted for purpose of determining the amount of net income subject to normal tax.

Credit of Interest. The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation to the extent that such interest has been included in the gross income may be deducted as a credit for the purpose of the normal tax.[50]

Credit of Tax Paid at the Source. If the estate is the owner of bonds on the interest of which the debtor corporation has agreed to pay any tax withheld at the source the law requires the debtor corporation to pay for the bondholder an amount equal to 2% of the interest paid during the year. This amount is a credit against the tax to be paid on the income of the estate or trust and should be divided proportionately among the beneficiaries and the estate according to the respective shares of the income to which each is entitled.

Credit for Taxes. The estate may be in a position to claim credit for taxes paid in foreign countries or possessions on income derived from sources in such foreign countries or possessions,[51] in which case the amount of such taxes is divided between the beneficiaries and the estate according to their respective shares of the income.

Specific Exemption. Section 216 of the law provides for a credit of the personal exemption and the exemption allowed for dependents. The beneficiaries of an estate will claim those credits, each according to his status. The fiduciary may claim for the purpose of the normal tax a

49 Id. § 216 (a).

50 Interest on a portion of the kinds of bonds enumerated in this paragraph may be omitted from gross income to the extent that such interest is wholly free from normal tax and surtax but to the extent that interest on such bonds may be subject to surtax the amount of interest must be included in gross income and deducted as a credit.

51 See Rev. Act of 1918, § 222 (a).

deduction of $1,000 in this respect from that portion of the income on which he is required to report and pay tax.[52]

Distribution of Income of Trust Estates. When any part of the net income of a trust estate for any year is distributable to the beneficiaries, a fiduciary is required to report on Form 1041 the respective amounts paid or credited to each beneficiary. The beneficiaries are required to report such amounts in their personal returns and add the same to income from other sources in order to determine their respective tax liabilities. They are entitled to their proportionate shares of the credits for normal tax as indicated in the preceding paragraphs. The object of the law seems to be to tax (1) the respective beneficiaries upon income of estates or trusts which can be definitely and legally assigned to them during the year, and (2) to tax the estate or trust as an entity upon all income which cannot be definitely and legally assigned to some beneficiary. In other words, beneficiaries are taxed when their distributive shares can be definitely determined, and if their distributive shares cannot be definitely determined at the close of the year the tax is imposed upon the estate.[53] The Revenue Act of 1918 provides that the tax shall not be paid by the fiduciary upon (a) income which it to be distributed to the beneficiaries periodically, whether or not at regular intervals, (b) income collected by a guardian of an infant to be held or distributed as the court may direct, and (c) income of an estate during the period of administration or settlement properly paid or credited to any legatee, heir or other beneficiary.[54] For purposes of convenienee income included in (a), (b) and (c) will be referred to hereafter as "distributable income." In the case of (a), (b) and (c), above, there is included in computing the net income of each beneficiary

[52] Rev. Act of 1918, § 219 (c).

[53] See T. D. 2231; letter from Treasury Department dated October 19, 1915; I. T. S. 1918, ¶ 733. Rev. Act of 1918, § 219.

[54] Rev. Act of 1918, § 219 (a), (c) and (d); Reg. 45, Art. 344.

his distributive share, whether distributed or not, of the net income of the trust estate, for the taxable year, or if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the trust estate is computed, then his distributive share of the net income of the trust estate for any accounting period of such trust estate ending within the fiscal or calendar year, upon the basis of which such beneficiary's net income is computed.[55]

INCOME NOT ACTUALLY PAID TO BENEFICIARIES IN YEAR. It will be noted that in the case of so-called "distributable income" the tax is paid by the beneficiary upon his distributable share *whether or not it is actually distributed.* In other words there may be an actual or constructive distribution of the income of an estate. When it is credited or made available to the beneficiary, it is to be accounted for by the beneficiary as if it were actually paid over. Where the tax on such income constructively distributed has been paid by the beneficiary, it is not again payable when at a later date the income is actually turned over to him.[56]

DISTRIBUTION OF INCOME OF SEVERAL YEARS. Where a decedent died in 1913, leaving a will devising a part of his estate in trust to pay the income therefrom to one beneficiary during life, and other parts to be divided

[55] Rev. Act of 1918, § 219 (d). In the case of a partnership or personal-service corporation having a fiscal year, the distributive shares of the partners or members for any fiscal year ending in 1918 or 1919 are taxed in proportion to the part of the fiscal year falling within the calendar years 1917, 1918 or 1919, as the case may be, at the rates in force in those years. (See Revenue Act of 1918, § 205 and § 206.) But the law does not authorize beneficiaries of estates or trusts with fiscal years ending in 1918 or 1919 to similarly apportion the net income from the estate or trust. All such income is taxable at the rate in force in the calendar year in which the fiscal year ends if the beneficiary reports for the calendar year.

[56] Reg. 33 Rev., Art. 29; T. D. 2289; Reg. 33, Art. 75. The theory seems to be that such income is separated from the estate when it is credited to the beneficiary, the fiduciary thereafter holding it, not as fiduciary, but as agent for the beneficiary.

among other beneficiaries, and it was impracticable for the executors to complete distribution of the estate or determine the amount of net income until 1916, at which time an account was prepared showing the net income accruing to each beneficiary during the last three months of 1913 and during the years 1914 and 1915, a large part of the accumulated income being distributed in 1916, it was held that the executors should make a fiduciary return for each of the years 1913, 1914, 1915 and 1916, reciting therein the respective beneficiaries and their interests and the beneficiaries could make amended returns for such of those years in which they would be taxable by reason of the amount so distributed.[57] In this case, apparently, the respective shares of the beneficiaries were known at all times, but the amount of net income of the estate was not determinable until 1916.

Undistributed Income. The Revenue Act of 1918 provides that the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary upon (a) income received by estates of deceased persons during the period of administration or settlement of the estate and not paid or credited to any legatee, heir or other beneficiary during that period, (b) income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, (c) income held for future distribution under the terms of the will or trust. For convenience the income referred to in (a), (b), and (c) above will be called "undistributed income" in the following discussion.[58] Where the tax

[57] Letter from Treasury Department dated March 24, 1917; I. T. S. 1918, ¶ 728.

[58] The 1913 Law was silent as to the taxability of undistributed income of trust estates. It was first held by the Treasury Department that if income was added to the corpus of the estate, under the provisions of the will or under a statute, no tax would accrue with respect thereto, but it was later held under that law that such income was taxable, on the theory that an estate could not be without a beneficiary for income tax purposes. Where the beneficiaries and their beneficial interest were known, the income was to be reported as

has been paid on the undistributed net income of an estate or trust by the fiduciary, such income is free from tax when later actually distributed to the beneficiaries.[59]

Receiver in Partition Proceedings. A receiver in partition proceedings was required under the 1916 Law to report at the close of each year during the pendency of the partition suit, the net income collected from the property during such year, and pay the tax thereon.[60] Where an executor under a will is also receiver in partition proceedings the income accruing to him as receiver should be reported separately and not added to the income received by him as executor, if the receivership is separate and apart from the matter of administration and settlement of the estate.

accruing to them, and the estate itself was to be listed as a beneficiary with respect to any of its income not otherwise beneficially assigned or accounted for. (T. D. 2231.) The executor or administrator of an estate was required to make no return of the income until the settlement of the estate had reached the stage where the beneficiaries and their respective interests in the income were determinable, at which time returns should be made showing the annual accrual, a separate return being required for each tax year involved. (Letter from Treasury Department dated March 4, 1916; I. T. S. 1917, ¶ 576; T. D. 2289; T. D. 2231 and T. D. 1943.) The 1916 Law provided that "income received by estates of deceased persons during the period of administration or settlement of the estate, shall be subject to the normal and additional tax and taxed to their estates, * * *." (§ 2 (b).) It has been indicated by the Treasury Department that under the 1916 Law the income received by an estate of a decedent during the period of administration or settlement was intended to be taxed as an entity whether or not any amounts were paid over to legatees, heirs, or other beneficiaries during that period, but the language of § 2 (b) of the 1916 Law seems to indicate that the law intended the tax to be imposed on the estate "except where the income is returned for the purpose of the tax by the beneficiary" and the construction generally placed upon the provisions of the 1916 Law was that the executor or administrator became liable for the tax only on the amount not paid over to a legatee or heir during the year.

59 Rev. Act of 1918, § 219 (a) and (c). See also Reg. 45, Art. 343.

60 Letter from Treasury Department dated March 14, 1917; I. T. S. 1918, ¶ 1004.

Returns by Fiduciaries. A fiduciary is responsible for making the return of income for the estate or trust for which he acts.[61] He is required to make a return of income on or before March 15th in each year or the fifteenth day of the third month following the close of the fiscal year of the individual, estate or trust for which he acts, accordingly as he reports upon the basis of the calendar or a fiscal year. The return is required to state specifically the items of gross income received and the deductions and credits allowed against such gross income, the net income, and the respective amounts distributed to the respective beneficiaries or retained by the estate as undistributed income.[62]

BY WHOM FILED. The return is filed by the fiduciary having charge of the trust estate. Fiduciaries required to make returns are subject to all the provisions of the law which apply to individuals. Under such regulations as the Commissioner, with the approval of the Secretary, may prescribe, a return made by one of two or more joint fiduciaries and filed in the office of the Collector of the district where such fiduciary resides, is a sufficient compliance with the requirements of the law.[63]

WHEN A RETURN IS REQUIRED. Every fiduciary (except receivers appointed by authority of law in possession of part only of the property of an individual) must make a return (a) for the individual whose income is in his charge, if the net income of such individual is $2,000 or over, if married and living with husband or wife, or is $1,000 or over in other cases, or (b) for the estate or trust for which he acts, if the net income of such estate or trust is $1,000 or over or if any beneficiary of such estate or trust is a non-resident alien.[64]

61 Revenue Act of 1918, § 219 (b).

62 Revenue Act of 1918, § 225.

63 Revenue Act of 1918, § 225.

64 Revenue Act of 1918, § 225; Reg. 45, Art. 342. The return in case (a) and also in case (b) if the tax is payable by the fiduciary shall be on Form 1040 (revised), except that it may be on short

FIDUCIARIES ACTING IN MORE THAN ONE ESTATE. In the case of two or more trusts the income of which is taxable to the beneficiaries, which were created by the same person and are in charge of the same trustee, the trustee shall make a single return on form 1041 (revised) for all such trusts, notwithstanding that they may arise from different instruments. When, however, a trustee holds trusts created by different persons for the benefit of the same beneficiary, he shall make a return on form 1041 (revised) for each trust separately.[65]

WHERE FILED. The return of annual net income should be filed in the collection district in which the fiduciary resides or has his place of business, regardless of the residence of the beneficiaries.[66] Where an estate has two or more joint fiduciaries the return may be filed by one of them, in the district where he resides, such filing being sufficient compliance with the law.[67]

WHEN FILED. The return must be filed on or before

Form 1040-A (revised) where the net income does not exceed $5,000. The return shall be on Form 1041 (revised) in case (b) if the tax is payable by the beneficiaries. Under the 1916 Law a return was required whenever the income payable to any one beneficiary including dividends exceeded the minimum specified by law. (Letter from Treasury Department dated January 4, 1917; I. T. S. 1918, ¶ 779.) Fiduciaries were required to make returns of income on Income Tax Form 1041 whenever the interest of any beneficiary in the net income of an estate or trust for which the fiduciary acted was $1,000 or over for an unmarried beneficiary, and in case there were married beneficiaries, then a return was required whenever the interest of any such married beneficiary was $2,000 or over. (Reg. 33 Rev., Art. 27.) In the 1913 Law there was no specific provision taxing the undistributed income of decedents' estates, and it was held that no return need be made by a fiduciary until the settlement of the estate had reached a stage where the beneficiaries thereof and their respective interests in the income of the estate were determinable, and thereafter a fiduciary was required to file a return on or before March 1st of each year. (T. D. 1943.) The 1916 Law required a return annually while the estate was in process of settlement.

65 Reg. 45, Art. 423; T. D. 2090, T. D. 2137.

66 Revenue Act of 1918, § 227 (b).

67 Revenue Act of 1918, § 225.

March 15th in each year or on or before the fifteenth day of the third month following the close of the fiscal year of the estate or trust accordingly as it reports upon the basis of the calendar or a fiscal year.[68]

EXTENSION OF TIME. The same extension of time may be granted for filing the returns of fiduciaries as may be granted to individuals.

PREPARATION OF ANNUAL RETURN. The annual return of a trust estate is prepared in the manner indicated on the form supplied by the Government. No special rules are applicable to fiduciaries, except that in the case of income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and in the case of income collected by a guardian of an infant to be held or distributed as the court may direct, the fiduciary is required to include in his return a statement of each beneficiary's distributive share of the net income of the estate or trust, whether or not distributed before the close of the taxable year for which the return is made.[69]

HOW SIGNED AND SWORN TO. The law provides that the fiduciary shall make oath that he has sufficient knowledge of the affairs of the individual, trust, or estate for which he acts, to enable him to make the return and that the same is, to the best of his knowledge and belief, true and correct.[70] When the return is signed and sworn to by an individual as a fiduciary his full address was required to be stated, under the 1916 Law. If the fiduciary was an organization, the return was signed and sworn to by the president, secretary or treasurer.[71]

Returns for Beneficiaries. As a general rule the fidu-

68 See Chapter 34 on Returns. The annual return under the 1916 Law was required to be filed in all cases on or before March 1st of the year following that for which the income was reported. Although a fiduciary might be a corporation, no privilege was extended for the filing of the return for any other period than the calendar year.

69 Revenue Act of 1918, § 219 (b).

70 Revenue Act of 1918, § 225.

71 Reg. 33, Art. 73.

ciary is not required to make any return of distributed income as the term is defined in a previous paragraph for and on behalf of his beneficiary.[72] If, however, the fiduciary has been legally authorized to act as agent for the beneficiary, or as attorney-in-fact, he may also make and file the personal return of the beneficiary in the same manner as any other duly authorized agent may do.[73] If the beneficiary is unable to make his own return, or is a non-resident alien, the fiduciary is required to make the personal return for him, as indicated in the following paragraphs.

For Minors or Insane Persons. Under the 1916 Law where the fiduciary acted for a single beneficiary who was a minor or an insane person, he was not required to file a fiduciary return for the trust estate (Form 1041) but could make a personal return for his ward on the form prescribed for individuals (Form 1040). If, however, a fiduciary had more than one ward by reason of the same estate or trust, he made the fiduciary return, and also a separate return for each ward having a net income of $1,000, if unmarried or $2,000, if married.[74] In all cases where fiduciaries acted for minors or incompetents they were held for the purpose of the income tax to be acting as the agents of such minors or incompetents and were required to pay all tax normal and additional chargeable on such income in their hands, as though the persons for whom they acted were acting for themselves.[75] Under the present law it is ruled that a fiduciary acting as the guardian of a minor having a net income of $1,000 or $2,000, according to the marital status of such person, must make a return for such minor and pay the tax, unless such minor himself makes a return or causes it

72 See page 127.

73 See Reg. 33, Art. 72.

74 T. D. 2090. In the year in which a minor became of age, the guardian made a fiduciary return under the 1916 Law for the period between the beginning of the year and the day on which the beneficiary became of legal age. At the close of the year the beneficiary made his own return including therein the amount of income received from the fiduciary during the year.

75 T. D. 2231.

to be made. A fiduciary acting as the committee of an insane person having an income of $1,000 or $2,000, according to the marital status of such person, must make a return for such incompetent and pay the tax. In either case, if the fiduciary is also acting for other beneficiaries, such a return shall be rendered in addition to the returns required for the trust estate.[76]

For Non-Resident Alien Beneficiaries. When there is only one beneficiary, who is a non-resident alien, the fiduciary files only one return, that is, the personal annual return for and on behalf of the non-resident alien [77] signing the same as agent, reporting therein as income of the nonresident beneficiary the amount received by the estate or trust. If there are two or more beneficiaries, or if a part of the income accruing to the trust or estate is not distributed, the fiduciary is required to make a return as fiduciary and a separate personal return for each non-resident alien beneficiary.[78] Under the 1916 Law the fiduciary was required to account for the normal and additional tax of non-resident alien beneficiaries in the same manner as any other agent for a non-resident alien was required to do.[79]

Income to Be Reported by Beneficiary. Unless the beneficiary is under some disability which requires a fiduciary to act, the beneficiary makes his own personal return and accounts for the tax upon his entire net income, including that which has been received from the estate.[80] The fiduciary is not under any duty to account for or pay the tax on amounts distributed to beneficiaries where the beneficiary is capable of making his own return and is not a non-resident alien. The beneficiary reports the income for

[76] Reg. 45, Art. 422. Form Nos. 1040 (revised) or 1040-A (revised) are used for this purpose.

[77] Reg. 45, Art. 425. Form Nos. 1040 (revised) or 1040-A (revised) are used for this purpose.

[78] Reg. 45, Art. 425; T. D. 2313. Form No. 1041 (revised) and Nos. 1040 or 1040-A are used for this purpose.

[79] See Chapter 6 on Resident Agents for Non-Resident Aliens.

[80] See T. D. 2090. See page 119.

the year in which it is received by him or credited to him. All amounts paid by fiduciaries to beneficiaries of trust estates from the income of such trust estates whether from reserves or otherwise, are held to be distributions of income and will be treated for income tax purposes in accordance with the provisions of law and regulations applicable to income of such beneficiaries. The beneficiary will be required in the case of trust estates to account for the actual amounts distributed or credited to him.[81]

Returns of Executors and Administrators. In addition to the duties which executors and administrators have in common with other fiduciaries, they are also required to report the income of the decedent for that part of the last taxable year during which he lived; and also for the preceding taxable year, if the decedent died before the time for filing returns for such year had expired and no return had been filed by him. Thus, if a decedent died in February, 1919, without having made a return for 1918 the executor or administrator is required to file a return for 1918 and a return for the part of 1919 in which the decedent lived.[82] If the net income of the decedent, from January 1 of the year in which he died to the date of his death, was less than the sum which would have made him liable to make a return if living, no return is required by the executor or administrator.[83] The personal exemption which may be deducted from the decedent's income so reported is the full amount allowed to living persons of the same status as

81 Reg. 33 Rev., Art. 29. See Revenue Act of 1918, § 219.

82 Revenue Act of 1918, § 223. Returns seem to be required of executors or administrators in such cases on the theory that by reason of death the decedent is unable to make his own return, a return therefore being required by the "person charged with the care of the person or property of such taxpayer." See Brady v. Anderson, 240 Fed. 665, writ of certiorari denied 244 U. S. 654; Mandell v. Pierce, 3 Cliff. 134, 16 Fed. Cas. No. 9008; Reg. 33 Rev., Arts. 4 and 14. This subject is discussed more fully in Chapter 3 on Individuals to whom the Law is Applicable.

83 Revenue Act of 1918, § 223; Reg. 45, Art. 421. See also T. D. 2090 and Reg. 33, Art. 17.

that of the decedent at the time of his death, or at the end of the last taxable year he lived.[84] Administrators or executors may, immediately after their discharge, upon final accounting, file with the proper collector of internal revenue a return of income for the income of the estate for the calendar year in which the administration was closed, and should pay the tax found by such return to be due immediately upon receipt of notice and demand for the amount of such tax. There should be attached to this return a copy of the certificate, under seal, setting forth the fact of final accounting and discharge of the executor or administrator.[85]

LIABILITY OF EXECUTORS FOR TAX. Liability for payment of the income tax attaches to the person of the executor or administrator for income tax, up to and including the date of his discharge, where prior to distribution and discharge he had notice of his obligations or failed to exercise due diligence in determining whether or not such obligations existed. Liability also follows the estate itself, and when, by reason of the distribution of the estate and the discharge of the executor or administrator, it appears that the collection of the tax cannot be made from the executor or administrator, the legatee or distributees must account for their proportionate share of the tax due and unpaid. The same rule applies to other trusts.[86]

Withholding at the Source Against Fiduciaries. The provisions with respect to withholding the tax at the source apply in the case of payments to fiduciaries in the same manner as in the case of payments to individuals. There is, generally speaking, no withholding at the source on payments to citizens and residents of this country and, it follows that there is no withholding at the source in the case of a fiduciary who is a citizen or a resident, or has an office or place of business in this country. The one exception to this

[84] Reg. 33 Rev., Art. 14. See Chapter 4 on Citizens and Residents of the United States.

[85] Reg. 33 Rev., Art. 26.

[86] Reg. 45, Art. 343; Reg. 33 Rev., Art. 29.

rule is the withholding of a tax equal to 2% on interest paid on obligations of corporations containing a tax-exempt covenant. In such cases the tax is in theory withheld, but not in actual fact, since the paying corporation assumes the burden of the tax, paying the interest in full to its bondholder. Although the fiduciary may be a corporation, in its capacity as fiduciary, it is subject to the provisions of law applicable to individuals and not to corporations; hence on payments of such interest as that referred to in the preceding sentence, the paying corporation will be required to treat the corporation fiduciary as an individual and assume the burden of the 2% tax.[87]

Withholding at the Source by Fiduciaries. A fiduciary is expressly required to withhold the tax at the source in the same cases in which individuals, corporations and partnerships are required so to do; that is, the tax must be withheld at the source by a fiduciary upon all annual or periodical payments of fixed and determinable income to non-resident aliens and non-resident foreign corporations.[88]

Information at the Source. The fiduciary is expressly subject to all the provisions of the law requiring information at the source. These requirements are discussed in full in a subsequent chapter.[89]

Penalties. The Revenue Act of 1918 provides that fiduciaries required to make returns shall be subject to all the provisions which apply to individuals.[90] Fiduciaries are liable to the same penalties, so far as they are applicable, as those which may attach to individuals and which are discussed at length in another chapter.[91]

[87] See Chapter 40 on Collection of the Tax at the Source.

[88] Revenue Act of 1918, §§ 221 and 237. See Chapter 40 on Collection of the Tax at the Source.

[89] See Chapter 39 on Information at the Source.

[90] Revenue Act of 1918, § 225.

[91] See Chapter 36 on Penalties and Compromises.

CHAPTER 9

FOREIGN FIDUCIARIES

The Revenue Act of 1918 requires every fiduciary (with the exception of receivers in possession of part only of the property of an individual) to make a return for the individual, estate or trust for which he acts (1) if the net income of such individual is $1,000 or over, if single, or of married and not living with hubsand or wife, or $2,000 or over if married and living with husband or wife, or (2) if the net income of such estate or trust is $1,000 or over, or if any beneficiary of such estate or trust is a non-resident alien.[1] It is further provided[2] that "fiduciaries required to make returns under this Act shall be subject to all the provisions of this Act which apply to individuals." The law implies that foreign fiduciaries shall be subject to its provisions to the same extent as non-resident alien individuals. The term "foreign fiduciaries" is defined, for the purpose of this book, as fiduciaries who neither reside in this country nor have an office or place of business here, that is, those who are not within the jurisdiction of this Government.[3] The preceding chapter contains the general rules relating to fiduciaries. This chapter treats of the application of those rules to foreign fiduciaries.

Trust Estates. The trust estate under the control of a foreign fiduciary is subject to tax on net income de-

[1] Revenue Act of 1918, § 225.

[2] Revenue Act of 1918, § 225.

[3] As to who are fiduciaries and who are beneficiaries within the meaning of the law, and as to the special duties of executors, administrators and receivers, see the preceding chapter.

rived from sources within this country. Net income from sources within this country is determined under the same rules as apply to non-resident aliens.[4] The deductions claimed by the foreign fiduciary are governed by the rules relating to fiduciaries in general, except so far as they are limited by rules relating to the deductions allowed to non-resident aliens.

Distribution of Income of Trust Estates. A foreign fiduciary having charge of an estate or trust the income of which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, or a non-resident alien guardian of an infant where income is collected and held or distributed as the court may direct, is required to execute the same annual return as is required of domestic or resident fiduciaries, that is, they will include in their returns a statement of every beneficiary's distributable share of the net income of the trust estate from sources in the United States.[5] Under the 1916 Law such fiduciaries were also required to file a personal return on behalf of each non-resident alien beneficiary[6] and if there was only one beneficiary who was a non-resident alien and to whom all of the income was distributed annually, it was only necessary to file the personal return on behalf of the beneficiary and not also a fiduciary's return for the trust estate. If the foreign fiduciary acts for beneficiaries who are citizens or residents of this country no personal return need be filed on behalf of such beneficiaries, but a fiduciary's return must be filed and in this return must be included a statement of each beneficiary's distributable share of the net income.[7] The discussion in the preceding chapter on the subject of distribution of income of trust estates should be read in this connection.

Undistributed Income of Trust Estates. The term "un-

[4] See Chapter 5 on Non-Resident Aliens.

[5] Revenue Act of 1918, § 219 (b).

[6] Letter from Treasury Department dated December 28, 1916; I. T. S. 1918, ¶ 115.

[7] Revenue Act of 1918, § 219 (b).

distributed income'' of trust estates is discussed in the preceding chapter. In the case of (1) income received by estates of deceased persons during the period of administration or settlement of the estate; (2) income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests; or (3) income held for future distribution under the terms of the will or trust, the foreign fiduciary having charge of such estates will be responsible for making the return of such income and the tax will be imposed upon the estate or trust and will be paid by the foreign fiduciary, except that in the case of the estate of any deceased person during the period of administration or settlement the tax is imposed on the beneficiary with respect to the amount of any income properly paid or credited to any legatee, heir or other beneficiary and on the executor or administrator only with respect to the remainder.[8] For the purposes of the normal tax the estate or trust will be allowed the same credits as are allowed to single persons. Under the 1916 Law, the foreign fiduciary might claim the specific exemption allowed to single persons only if the estate was created by a citizen or resident of this country,[9] but under the Revenue Act of 1918 it seems that the specific exemption of $1,000 may be claimed for the estate irrespective of whether or not the person creating the estate was a citizen or resident or non-resident alien.[10]

Returns. Under the Revenue Act of 1918, a foreign fiduciary is required to make under oath a return for the individual, estate or trust for which he acts, stating specifically the items of the gross income received from sources within this country, and the deductions and credits allowed by the law, and the respective shares distributable to beneficiaries. The fiduciary is required to make oath that he has sufficient knowledge of the affairs of the indi-

[8] Revenue Act of 1918, § 219.
[9] Revenue Act of 1916, § 7.
[10] Revenue Act of 1918, § 219 (c).

vidual, estate or trust for which he acts to enable him to make the return, and that the same is, to the best of his knowledge and belief, true and correct.[11]

By Whom Filed. The return is filed by the fiduciary having charge of the trust estate. In making the return he should comply with the law and regulations respecting returns by non-resident aliens. The Revenue Act of 1918 provides that a return may be made by one of two or more joint fiduciaries, under such regulations as the Commissioner with the approval of the Secretary may prescribe.

When a Return is Required. The Revenue Act of 1918 requires a return to be made by a fiduciary for the individual, estate or trust for which he acts (1) if the net income of such individual is $1,000 or over if single or if married and not living with husband or wife, or $2,000 or over if married and living with husband or wife, (2) if the net income of such estate or trust is $1,000 or over, or if any beneficiary of such estate or trust is a non-resident alien.[12] In the case of foreign fiduciaries the law is silent, but seemingly a return will be required by the Treasury Department if the foreign fiduciary has received any net income from sources within the United States during the taxable year.

Where Filed. In the case of foreign fiduciaries the return should be filed with the Collector at Baltimore, Maryland.[13]

When Filed. The annual return must be filed on or before March 15, or on or before the fifteenth day of the third month following the close of a fiscal year accordingly as net income is computed on the basis of the calendar year or a fiscal year.[14] The same general rules are applicable to the filing of returns by non-resident aliens and by foreign fiduciaries. The same extension of time

11 Revenue Act of 1918, § 225.
12 Revenue Act of 1918, § 225.
13 Revenue Act of 1918, § 227 (b).
14 Revenue Act of 1918, § 227 (a).

may be granted and the same penalties are imposed for neglect or failure to file.[15]

Withholding at the Source Against Foreign Fiduciaries. The provisions with respect to withholding the tax at the source apply, in the case of payments to foreign fiduciaries, in the same manner as in the case of payments to non-resident aliens. A foreign fiduciary may not receive the benefit of the specific exemption by filing a claim therefor with the withholding agent,[16] and cannot otherwise claim exemption from withholding of the tax at the source.[17] He may claim the benefit of deductions and credits and obtain a refund of any amounts withheld in excess of the tax liability of the estate, in the same manner as is prescribed with respect to non-resident alien individuals.[18]

Withholding at the Source by Foreign Fiduciaries. Since a foreign fiduciary is not personally within the jurisdiction of this Government, the requirements imposed upon domestic or resident fiduciaries to withhold the tax in paying net income to non-resident aliens, do not apply to such fiduciaries.

Information at the Source. A foreign fiduciary is under no duty to supply the Government with information at the source as to payments made to others, except so far as information is supplied with respect to beneficiaries in the return of annual net income.

15 See Chapters 34 and 36 on Returns and on Penalties.

16 Revenue Act of 1918, § 217. This provision of the law authorizes the Commissioner to permit non-resident aliens to claim exemption at the source, but no such permission has been granted. (Reg. 45, Art. 362.)

17 Letter from Treasury Department dated December 28, 1916; I. T. S. 1918, ¶ 119.

18 See Chapter 5 on Non-Resident Aliens.

CHAPTER 10

PARTNERSHIPS AND PERSONAL-SERVICE CORPORATIONS

The Revenue Act of 1918 provides[1] that individuals carrying on business in partnership shall be liable for income tax only in their individual capacity and that there shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year,[2] or if his net income is computed upon the basis of a period different from the basis upon which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any annual accounting period of the partnership ending within the

1 Revenue Act of 1918, § 218 (a). Partnerships as such were not taxable under the 1916 Law the partners thereof being taxable in their individual capacity. (Revenue Act of 1916, § 8 (e); T. D. 1957.) Partnerships were expressly excepted from the tax on corporations. (Revenue Act of 1916, § 10.) In U. S. v. Coulby, 251 Fed. 982, arising under the 1913 Law, the court said in part: "This law, therefore, ignores for taxing purposes the existence of a partnership. The law is so framed as to deal with the gains and profits of a partnership as if they were the gains and profits of the individual partner. * * * The law looks through the fiction of a partnership and treats its profits and its earnings as those of the individual taxpayer. Unlike a corporation, a partnership has no legal existence aside from the members who compose it. The Congress, consequently, it would seem, ignored, for taxing purposes, a partnership's existence and placed the individual partner's share in its gains and profits on the same footing as if his income had been received directly by him without the intervention of a partnership name."

2 See the definition of the term "taxable year" in the next paragraph.

fiscal[3] or calendar year upon the basis of which the partner's net income is computed.[4] An important new provision[5] is contained in the Revenue Act of 1918 taxing the individual stockholders of personal-service corporations in the same manner as the members of partnerships. This subject is discussed in a subsequent paragraph of this chapter, as well as the new requirement of the Revenue Act of 1918 that partnerships file returns for each taxable year.[6]

Definition. For the purpose of the discussion in this and the following chapter, general partnerships are divided into two classes, domestic and foreign. A domestic partnership is defined as one which has its principal place of business in this country and directs all or the greater part of its business from its office or offices in this country, whether or not the partners are citizens or aliens, residents or non-residents. This distinction seems to be more logical than one based on the situs of the contract or articles of partnership, since a partnership is not a distinct entity apart from the members.[7] The definition of "foreign partnership" is found in the following chapter. The term "taxable year," used in this chapter as defined in the law,[8] means the calendar year or the fiscal year ending during such calendar year, upon the basis of which

[3] For a general discussion on the subject of reporting on the basis of the fiscal year, see Chapter 34 on Returns.

[4] See p. 152 as to rates of tax applicable where fiscal year of partnership falls in calendar year in which rates are changed.

[5] Revenue Act of 1918, § 218 (e).

[6] See Revenue Act of 1918, § 224.

[7] Under the 1918 Law and the regulations a domestic partnership is defined as one organized or created in the United States, including only the states, the territories of Alaska and Hawaii, and the District of Columbia, and a foreign partnership is one created outside the United States as so defined. The nationality or residence of members of a partnership does not affect its status. Thus, a partnership created by articles entered into in San Francisco between residents of the United States and residents of China is held to be a domestic partnership. (Reg. 45, Art. 1508.)

[8] Revenue Act of 1918, § 200.

the net income of the partnership is computed. The first taxable year, called the taxable year 1918, is the calendar year 1918 or any fiscal year ending during the calendar year 1918.

Limited Partnerships. Limited partnerships were first broadly and without any qualifications held to be in the same category as corporations or associations under the 1916 Law and subject to the income tax imposed on such entities. The profits of limited partnerships so reporting were treated as dividends and were not subject to the normal tax in the hands of the partners receiving them but were subject to the additional or surtaxes in the hands of such partners.[9] A limited partnership was defined as a form of business organization created by statute in many of the United States, wherein the liability of certain special partners, who contribute a specific amount of capital, is limited to the amount so contributed, while the general partners of the same partnership are jointly and severally responsible as in ordinary partnerships.[10] It was held that a limited partnership would be classed as a quasi-corporation or association within the meaning of the law.[11] The Treasury Department later modified this ruling, drawing a distinction between limited partnerships of the Penn-

9 Reg. 33 Rev., Art. 62; Reg. 33, Art. 86; T. D. 2137. Under the 1909 Law it was held that a limited partnership was liable for the tax, if organized for profit and having a capital stock represented by shares, although no "certificates of stock" were issued. (Op. Atty. Gen. Feb. 14, 1910.)

10 Reg. 33 Rev., Art. 62.

11 In a letter dated January 19, 1916, written with particular reference to limited partnerships of the type created under the New York Statute, Laws of 1897, Ch. 427, § 3D, the Treasury Department gave its reasons for classifying limited partnerships with corporations. After quoting the language of Revenue Act of 1916, §10 (a), which imposed a tax on "every corporation, joint-stock company or association, or insurance company * * * but not including partnerships" the letter stated that the term "partnership" as there used was a common law term and applied only to such partnerships as were known to the common law. As stated in the text above, this ruling has now been modified.

sylvania type and New York type and holding that, for purposes of the income, war excess profits and capital stock taxes, limited partnerships of the New York type were partnerships and limited partnerships of the Pennsylvania type were corporations or joint stock-companies.[12] So-called limited partnerships of the type authorized by the statutes of New York and most of the States are partnerships and not corporations within the meaning of the statute. Such limited partnerships, which can not limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe the statutory conditions, which are dissolved by the death or attempted transfer of the interest of a general partner, and which can not take real estate or sue in the partnership name, are so like common law partnerships as to render impracticable any differentiation in their treatment for tax purposes. Michigan and Illinois limited partnerships are partnerships. A California special partnership is a partnership.[13] On the other hand, limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and of a few other States are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, and capable of holding real estate and bringing suit in the common name, are more truly corporations than partnerships and must make returns of income and pay the tax as corporations. The income received by the members out of the earnings of such limited partnerships will be treated in their personal returns in the same manner as distributions on the stock of corporations. In all doubtful cases limited partnerships will be treated as corporations un-

[12] T. D. 2711. Letter from Treasury Department dated May 4, 1918; I. T. S. 1918, ¶ 3355. Telegram from Treasury Department dated April 24, 1918; I. T. S. 1918, ¶ 3325.

[13] Reg. 45, Arts. 1505, 1506; T. D. 2711.

less they submit satisfactory proof that they are not in effect so organized.

PARTNERSHIP ASSOCIATIONS. Under the 1909 Law the Attorney General held that partnership associations organized under the laws of Pennsylvania (referred to in the foregoing paragraph as "limited partnerships of the Pennsylvania type"), possessing every privilege and power essential to a corporation were properly taxable as corporations.[14] Such associations have capital contributed by the partners, who are not individually liable beyond the unpaid capital subscribed by each. The other characteristics which are more in the nature of a corporation than of a partnership are that the word "Limited" must be a suffix to the name, the interest of a partner may be transferred and new partners may be taken in by vote of a majority of the partners, and the association may sue or be sued in the association name. Michigan and Virginia partnership associations are of this type and held to be taxable as corporations.[15]

DIVIDENDS FROM LIMITED PARTNERSHIPS. The profits of limited partnerships of the Pennsylvania type should be treated by the members of the partnership as dividends of corporations are treated by stockholders.[16] Members of limited partnerships should ascertain if the partnership is paying a tax according to this requirement and if so the normal tax should not again be paid on their shares of the profits.

PRIVATE OR PARTNERSHIP BANKS. A partnership bank conducted like a corporation and so organized that the interests of its members may be transferred without the consent of the other members is a joint-stock company or association within the meaning of the statute. A partnership bank the interests of whose members can not be so transferred is a partnership.[17]

14 28 Op. Atty. Gen. 189 (1910).
15 Reg. 45, Art. 1506.
16 T. D. 2137.
17 Reg. 45, Art. 1503; T. D. 2137.

JOINT OWNERSHIP AND JOINT ADVENTURE. Joint investment in and ownership of real and personal property not used in the operation of any trade or business and not covered by any partnership agreement does not constitute a partnership. Co-owners of oil lands engaged in the joint enterprise of developing the property through a common agent are not necessarily partners. In the absence of special facts affirmatively showing an association or partnership, where a vessel is owned by several individuals and operated by a managing owner or agent for the account of all, the relation does not constitute either a joint-stock association or a partnership. The participation of two United States corporations in a joint enterprise or adventure does not constitute them partners.[18]

General Partnerships. A general partnership, or what is known as a common law partnership, which Congress clearly intended to be exempt from the income law, is one which does not have a separate entity, but is composed of two or more individuals associated together for the purpose of carrying on a given business or transaction. Such a partnersihp has been defined by the courts as "a business organization in which every partner possesses full power and absolute authority to bind all the partners by his acts or contracts in relation to the business of the firm, in the same manner and to the same extent as if he held full power of attorney from them."[19] Among

18 Reg. 45, Art. 1507.

19 Letter from Treasury Department dated January 19, 1916. This letter held all limited partnerships to be corporations for income tax purposes, as stated above. (See note 11.) The definition given is known as the test of mutual agency and has been criticised, as being neither strictly logical nor entirely satisfactory, on the ground that agency results from the partnership and not the partnership from the agency and on the ground that the existence of a relation of mutual agency is the very question at issue. (See Boreing v. Wilson, 33 Ky. L. 14, 108 S. W. 914.) There is great conflict of authority in the American decisions on the subject. The so-called "intention" test is usually applied as between the partners while as to third persons the profit-sharing test is often applied. No one test seems to be conclusive, the existence of a partner-

the principal elements of a general partnership are community of ownership of the partnership property, mutual responsibility and powers in the conduct of the partnership business, mutual liability, joint and several, for the debts of the partnership and mutual interest in the profits of the same. Such partnerships are not subject to the tax, but the partners are taxed on their respective shares of the profits.[20]

Partnerships Consisting of Corporations. In a case arising under the 1913 Law several corporations, organized under the laws of Hawaii entered into a partnership with one another, the laws of Hawaii permitting such a combination for the transaction of any lawful business. The by-laws provided for management by representatives selected by the several partners who were to represent the partners according to their respective interests. There were no special partners and there was no partnership capital stock. The by-laws provided for the existence of the association for 45 years unless sooner terminated by mutual consent. It was held that this provision did not show any plan for changeability in the membership; that dissolution would probably be effected through the transfer of any partner's interest; and that the association must be treated for income tax purposes as a partnership.[21] But the participation of two corporations in a joint enterprise would not constitute them partners.[22]

Partnerships Operating Abroad. No distinction is made in the law or regulations issued under former laws between domestic partnerships which operate entirely within this country and those which operate partly abroad. A

ship being a question of fact upon which all the various tests may bear. (See Meehan v. Valentine, 145 U. S. 611; Haiku Sugar Co. v. Johnstone, 249 Fed. 103.)

20 Revenue Act of 1918, § 218.

21 Haiku Sugar Co. v. Johnstone, 249 Fed. 103. This case contains a discussion of the distinction between joint-stock companies and partnerships.

22 Reg. 45, Art. 1507.

partner's share of the net profits of the partnership is in all cases taxable in full if the partner is a resident or citizen of this country. If a partner is a non-resident alien many questions arise as to the extent to which he is properly taxable on the gains from business of the partnership conducted abroad. If the partnership is a limited partnership association under the provisions of some statute, similar to the Pennsylvania statute, the Government will undoubtedly hold that the partner is taxable to the same extent as though it were a corporation, but if it is a general partnership operating partly in a foreign country, the entire income therefrom can scarcely be considered as income arising within the United States, even though the partnership has an office in this country and the income is paid to the partner from that office, since a general partnership is not a separate entity interposed between the individual and the source of the income.[23]

Procedure in Collecting Income. With one exception, a domestic partnership is not subject to withholding at the source. But a partnership may be required to establish its identity and status by filing a certificate or statement showing it to be a partnership.[24] A new provision of the Revenue Act of 1918 requires withholding at the source against partnerships in the case of interest on bonds, mortgages, or deeds of trust or other similar obligations containing a so-called "tax-free covenant," thus giving partnerships as well as individuals the benefit of such covenants.[25] Partnerships as well as all other recipients of income will be required to disclose their identity in the case of receiving fixed and determinable income

[23] U. S. v. Coulby, 251 Fed. 982. A distinction is now made by the Treasury Department between domestic corporations operating entirely within this country and those operating entirely abroad. Reg. 45, Art. 92.

[24] T. D. 1957, T. D. 1998. Telegram from Treasury Department dated May 17, 1918; I. T. S. 1918, ¶ 3362. See Chapter 40 on Collection at the Source.

[25] Revenue Act of 1918, § 221. See Chapter 40.

from another under the provisions of law as to Information at the Source.[26]

Duty in Paying Out Income. A partnership is under the same duty in paying out income as is an individual or a corporation, that is, in all cases required by law the tax must be withheld on payments of income to non-resident aliens and non-resident foreign corporations[27] and information as to the name and address of the recipient must be obtained upon payment to other individuals or corporations and partnerships.[28]

Net Income of Partnerships. The net income of a partnership is computed in the same manner and on the same basis as the net income of an individual except that a partnership is, unlike individuals, not allowed to deduct charitable contributions or gifts made within the taxable year,[29] but it seems that the partners may consider the contributions of the partnership as their own contributions, pro rata. Under the 1916 Law, partnerships were not permitted to deduct the amount of their Red Cross contributions, but the partners in computing their individual income taxes might deduct their proportionate amounts of such contributions subject, of course, to the 15% limitation.[30]

Deductions. The deductions to which a partnership is entitled are the same as those allowed to individuals with the exception noted in the preceding paragraph.[31] In the

[26] See Chapter 39 on Information at the Source.

[27] Revenue Act of 1918, §§ 221 and 237.

[28] See Chapters 39 and 40 on Collection at the Source and Information at the Source.

[29] Revenue Act of 1918, § 218 (d); Reg. 45, Art. 321. As to the manner of computing the net income of partnerships under the 1916 Law, see Reg. 33 Rev., Art. 30.

[30] Telegram from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3436. Certain donations immediately and closely connected with the business of a partnership were held deductible under the 1916 Law. (Letter from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3437.) This subject is more fully considered in a later paragraph.

[31] Revenue Act of 1918, §§ 218 (d), 212.

case of limited partnerships of the Pennsylvania type reporting as corporations, the deductions should be made under the rules applicable to corporations. Such special rulings as were made under former laws with respect to deductions of partnerships are given below.

PROFIT SHARING. Where a partnership agreed with an expert to take charge of one of its departments upon a participation of profits basis by which the expert served without salary and received his compensation in the form of 20% of the net profits of the department at the end of the year, it was held that this arrangement established the relation of employer and employee, not that of partner, and that the amount of compensation paid to the expert constituted a proper item of business expense to be deducted in computing the taxable income accruing to the partnership members.[32]

INSURANCE PREMIUMS. Premiums paid on life insurance policies covering the lives of officers, employees or those financially interested in any business conducted as a partnership were not permitted to be deducted in computing the profits of a partnership for the purpose of determining the distributive shares of the partners.[33] On the maturity of such policies the amounts of premiums so paid (if not deducted from the net income of the years in which paid) were a proper deduction from the amount of the policy, the remainder constituting the taxable portion of the amount received.[34] The Revenue Act of 1918

[32] Letter from Treasury Department dated June 30, 1916; I. T. S. 1918, ¶ 666.

[33] Revenue Act of 1916 as amended by the Revenue Act of 1917, § 32 (the reference to § 9 is apparently a mistake, the reference being intended to § 8 (e)). Reg. 33 Rev., Art. 30. Under the 1916 Law, prior to the 1917 amendment, the Treasury Department permitted such premiums on life insurance to be deducted from year to year as paid and required the amount of the policy to be included in gross income in the year in which the policy matured and such amount was received. (T. D. 2090.)

[34] Letter from Treasury Department dated March 15, 1918; I. T. S. 1918, ¶ 3290.

expressly provides that premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy shall not be deductible from gross income.[35]

DONATIONS. Partnerships were entitled under the 1916 Law to deduct the amount of such donations as were immediately and closely connected with the trade or business of the partnership through securing to it some definite benefit or consideration. The rule as to what constituted such an immediate and close connection in the case of the partnerships was analagous to the rule applicable to corporations. Partnerships were required to accompany the deduction with a satisfactory explanation of the nature of the donation and its connection with the business of the partnership. Any donation allowed as a business expense would, of course, not be allowed to individual members of the partnership. Donations made by the partnership but not allowable as deductions by it were permitted to be prorated among the individual members.[36]

Distribution of Partnership Profits. The law has not been construed at any time to require the collection of the tax at the source on the distribution and payment of profits of a partnership to the partners. No ruling has yet appeared requiring such deduction on payments to non-resident alien partners.[37]

Profits to Be Reported by Partners. Income of a partnership accrues to the individual partner at the time his distributive interest is determined.[38] The distributive share of the net income of a partnership which a partner is required to include in his return is his proportionate share of the net income of the partnership, either (a) for

35 Revenue Act of 1918, § 215 (d).

36 Letter from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3437. See Reg. 33 Rev., Art. 134.

37 See I. T. S. 1918, ¶ 665.

38 Reg. 33 Rev., Art. 4.

the accounting period upon the basis of which the partner's net income is computed, or (b), if the partner's net income is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, for any accounting period of the partnership ending within the accounting period upon the basis of which the partner's net income is computed.[39] Both normal and surtaxes must be paid, except as noted below. When the annual profits are not distributed and paid to the partners, the respective interests of each partner in the undistributed profits for the year should be ascertained and the partners entitled thereto should include the amount of their respective interests in their annual returns as if the profits had been distributed and paid to them.[40] Such undivided annual profits of partnerships having been reported by the individual members thereof and the tax having been paid thereon, are not again taxable to the partners when actually distributed at a later date.[41] The distributive interests of the partners in the firm's net income should be the amount shown by the books when closed and not their distributive interests in the amount of income of the partnership represented by actual cash receipts, unless the partnership keeps its books on the basis of cash receipts and disbursements. Where accounts receivable, for instance, are entered on the books of the partnership as income and the amounts thereof are treated as debts due from customers or clients, the partners' returns are required to be based on the total sum of such accounts receivable and not on the amount thereof that has actually been paid.[42] A portion of the net income of the partnership for the taxable year may represent dividends or interest exempt from normal tax, interest from corporate bonds containing "tax-free cove-

[39] Reg. 45, Art. 321.

[40] Reg. 33, Art. 13. Revenue Act of 1918, § 218 (a).

[41] Reg. 33, Art. 14. Revenue Act of 1918, § 218 (a).

[42] Letter from Treasury Department dated February 28, 1916; I. T. S. 1918, ¶ 673. See also Revenue Act of 1918, § 212 (b).

nants" and interest on bonds which may be wholly exempt from income tax, in which case the rules stated in the following paragraphs apply.

DIVIDENDS. For the purpose of the normal tax a partner is allowed a credit of his proportionate share of the income received by the partnership as dividends from (a) a corporation which is taxable upon its net income, and (b) a personal-service corporation out of earnings or profits upon which income tax has been imposed.[43]

INTEREST ON NATIONAL BONDS. For the purpose of the normal tax only a partner is allowed a credit of his proportionate share of the income received by the partnership as interest upon the obligations of the United States and bonds issued by the War Finance Corporation which is included in the gross income of the partnership.[44] This credit of interest on national bonds for the purpose of the normal tax is unrestricted, because the interest on all national bonds is exempt from the normal tax. Interest upon obligations of the United States issued after September 1, 1917, and War Finance Corporation bonds is exempt from the surtax is only to a limited extent and as provided in the respective acts authorizing the issue of such obligations or bonds, as amended and supplemented.[45] The Revenue Act of 1918 provides that in the case of such obligations or bonds the interest shall be exempt only if and to the extent provided in the respective acts authorizing the issue thereof, as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer both under the income and war-profits and excess-profits taxes.[46] Under the 1916 Law, as amended, interest upon the obligations of the United States issued after September

[43] Revenue Act of 1918, § 218 (a); Reg. 45, Art. 321. See Chapter 23 on Income from Dividends.

[44] Revenue Act of 1918, §§ 218 (a), 216 (b); Reg. 45, Art. 321.

[45] The amount of the exemption in the case of each issue is discussed in Chapter 22 on Income from Interest.

[46] Revenue Act of 1918, § 213 (a) 4.

24, 1917, was required to be included in gross income of a partnership only to the extent to which the partnership's holdings exceed $5,000 par value,[47] this being the exemption granted in the Second Liberty Bond Act for purposes of the surtaxes then in force. It seems that under the Revenue Act of 1918 all interest upon obligations of the United States issued after September 1, 1917, and War Finance Corporation Bonds will be required to be included in the gross income of a partnership. When a partner computes his proportionate share of the income received by the partnership, he will be treated as the owner of a proportionate share of such bonds held by the partnership and will be entitled to exemption on account of such ownership as if he owned such proportionate part of the bonds directly. Thus, if he was a partner at the time of the original subscription by the partnership for bonds of the Fourth Liberty Loan he will be treated as an original subscriber for a proportionate part of such bonds subscribed for by the partnership and will be entitled to the collateral exemption of interest on bonds of the previous issue on account of such original subscription for bonds of the Fourth Liberty Loan as if he had subscribed directly for such proportionate part of the bonds.[48]

INTEREST ON BONDS OF STATES, POSSESSIONS AND POLITICAL SUBDIVISIONS. The interest received by the partnership on the obligations of a state or any political or taxing subdivision thereof and upon the obligations of the possessions of the United States might, under the 1916 Law, be deducted by a partner in proportion to his share of the total partnership profits.[49] It was unnecessary to provide for

47 See Form No. 1065.

48 Reg. 45, Art. 80; T. D. 2762. The subject of excluding exempt income from gross income is treated more fully in its general application to all classes of taxpayers in Chapter 22 on Income from Interest.

49 This was undoubtedly intended to give the partner the benefit of the same exemption as was accorded to individuals or corporations under § 4 of the Revenue Act of 1916, although that section referred only to "political subdivisions" while the provision relating

this deduction or credit under the Revenue Act of 1918, since such interest, as well as interest upon obligations of a territory or any political subdivision thereof or the District of Columbia and securities issued under the Federal Farm Loan Act, is excluded from gross income,[50] and will not appear in the net income of the partnership, which consists of its gross income less deductions

CREDIT FOR TAXES. The provision of the Revenue Act of 1918 that the tax computed shall be credited with the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country or to any possession of the United States is discussed elsewhere in this book.[51] Where such taxes have been paid by a partnership, the income tax of an individual member thereof will be credited with the member's proportionate share of such taxes of the partnership paid during the taxable year to a foreign country or to any possession of the United States, as the case may be. A partner who is an alien resident of the United States and a citizen or subject of a foreign country is entitled to such credit only for taxes paid or accrued to a possession of the United States, or to the foreign country of which he is a citizen or subject, and is not entitled to such credit for taxes paid or accrued to that

to partnerships refers to "political and taxing subdivisions." However, political subdivision has been construed to mean any subdivision of a state having the power to levy taxes so that the inclusion of the phrase "taxing subdivision" apparently did not extend any greater exemption to partners than to others.

50 Revenue Act of 1918, § 213 (b). It is provided that every person (the term "person" including partnerships) owning any of the obligations, securities or bonds enumerated in the law to be absolutely exempt from the income tax—which includes the bonds referred to in the text above—shall in his return of income submit a statement showing the number and amount of such obligations, securities and bonds owned by him and the income received therefrom in such form and with such information as the Commissioner of Internal Revenue may require. (Revenue Act of 1918, § 213 (b) 4.)

51 See Chapter 4 on Citizens and Residents and Chapter 27 on Deductions—In General.

country unless it allows a similar credit to citizens of the United States residing in that country.[52]

Fiscal Year. The net income of a partnership is computed generally in the same manner and on the same basis as the net income of individuals.[53] Its net income must be computed upon the basis of the partnership's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of the partnership. If no such method of accounting has been employed, or if the method employed does not clearly reflect income, the computation is made upon such basis and in such manner as in the opinion of the Commissioner of Internal Revenue does clearly reflect income. If the partnership's annual accounting period is other than a fiscal year, as defined in a later paragraph, or if the partnership has no annual accounting period or does not keep books, its net income will be computed on the basis of the calendar year.[54] If the net

[52] Revenue Act of 1918, § 222 (a) 4; Reg. 45, Art. 321.

[53] Revenue Act of 1918, § 218 (d).

[54] Revenue Act of 1918, § 212 (b). Prior to the enactment of the Revenue Act of 1918 reporting on the basis of a fiscal year was a privilege; now it is a requirement, if the books of the partnership are kept on the basis of a fiscal year. (See Chapter 34 on Returns.) Under the 1916 Law a partnership had the same privilege of fixing and making returns upon the basis of its own fiscal year as was accorded to corporations. In each case where the partnership's fiscal year differed from the calendar year it was required not less than 30 days prior to March 1, to give notice in writing to the collector of internal revenue of the district in which its principal place of business was located of the day it had designated as the closing day of its fiscal year. (Reg. 33 Rev., Art. 31.) If a fiscal year ended during 1916 or during a subsequent calendar year for which there was a rate of tax different from the rate of the preceding calendar year, the rate for the preceding calendar year applied to an amount of each partner's share of such partnership profits equal to the proportion which the part of such fiscal year falling within such preceding calendar year bore to the full fiscal year and the rate for the calendar year during which such fiscal year ended applied to the remainder of such profits. (Revenue Act of 1916, § 8 (e) as amended by the Revenue Act of 1917.) Prior to this amendment of

income of a partner is computed on the basis of a period different from that upon the basis of which the net income of the partnership is computed, then the partner's distributive share of the net income of the partnership for any annual accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed, is included in computing the net income of each partner.[55] If the fiscal year of a partnership ends during a calendar year for which the rates of tax differ from those for the preceding calendar year, then (1) the rates for such preceding calendar year shall apply to an amount of each partner's share of such partnership net income equal to the proportion which the part of such fiscal year, falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to the remainder.[56] In the case of an individual member of a partnership which makes return for a fiscal year beginning in 1917 and ending in 1918, his proportionate share of any excess profits tax imposed upon the partnership under the Revenue Act of 1917 with respect to that part of such fiscal year falling in 1917, shall be deducted from that part of the income subject to the 1917 rates and not from that part subject to the 1918 rates.[57]

DEFINITION. A fiscal year of a partnership, like a fiscal year of an individual, means an accounting period of twelve months ending on the last day of any month other than December.[58]

PARTNERSHIP MAKING RETURN FOR FISCAL YEAR BEGINNING IN 1917 AND ENDING IN 1918. If the fiscal year of a

the statute the Treasury Department held that where the fiscal year of a partnership ended at any time other than December 31st the total profits of the partnership were required to be reported as income of the partners for the calendar year in which the fiscal year of the partnership ended.

55 Revenue Act of 1918, § 218 (a).

56 Revenue Act of 1918, § 218 (b).

57 Revenue Act of 1918, § 218 (c).

58 Revenue Act of 1918, § 200.

partnership began in the calendar year 1917 and ended in the calendar year 1918, the rates of tax for the calendar year 1917 apply to the amount of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1917, and the rates for the calendar year 1918 to the amount of each partner's distributive share of such net income of the partnership attributable to the calendar year 1918. The amount of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1917 is found by determining the net income of the partnership for its entire fiscal year in accordance with the law applicable to the calendar year 1917, and the distributive share thereof of each partner, and then taking such proportion of that distributive share as the part of the fiscal year falling within the calendar year 1917 bears to the full fiscal year. The amount of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1918 is found by determining the net income of the partnership for its entire fiscal year in accordance with the law applicable to the calendar year 1918 and the distributive share thereof of each partner and then taking such proportion of that distributive share as the part of the fiscal year falling within the calendar year 1918 bears to the full fiscal year. Any deductions, exemptions, or credits to which the partner is entitled shall first be applied against his income subject to the rates for the calendar year 1918, unless of a kind plainly and properly chargeable against income taxable at the rates for the calendar year 1917. The proportionate share of a partner of any excess profits tax imposed upon the partnership under the Revenue Act of 1917, with respect to that part of the fiscal year falling within the calendar year 1917, is plainly and properly chargeable against income taxable at the rates for that year and shall be credited against such income of the partner. In determining the rates of tax applicable to the amounts of the distributive shares of the partners attributable to the calendar

years 1917 and 1918, respectively, the amounts subject to the rates for the calendar year 1918 shall be placed in the lower brackets of the rate schedule provided in the statute, and the amounts attributable to the calendar year 1917 in the next higher brackets of the rate schedule applicable to that year.[59]

PARTNERSHIP MAKING RETURN FOR FISCAL YEAR BEGINNING IN 1918 AND ENDING IN 1919. If the fiscal year of a partnership began in the calendar year 1918 and ends in the calendar year 1919, the rates of tax for the calendar year 1918 apply to the amount of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1918, and the rates for the calendar year 1919 to the amount of each partner's distributive share of such net income of the partnership attributable to the calendar year 1919. The amount of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1918 is found by determining the net income of the partnership for its entire fiscal year in accordance with the law applicable to the calendar year 1918 and the distributive share thereof of each partner, and then taking such proportion of that distributive share as the part of the fiscal year falling within the calendar year 1918 bears to the full fiscal year. The amount of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1919 is found by determining the net income of the partnership for its entire fiscal year in accordance with the law applicable to the calendar year 1919 and the distributive share thereof of each partner, and then taking such proportion of that distributive share as the part of the fiscal year falling within the calendar year 1919 bears to the full fiscal year. Any deduction, exemptions or credits to which the partner is entitled shall first be applied against his income

59 Reg. 45, Arts. 322 and 1621. Revenue Act of 1918, §§ 205 (c), 206, 335.

subject to the rates for the calendar year 1919, unless of a kind plainly and properly chargeable against income taxable at the rates for the calendar year 1918. In determining the rates of tax applicable to the amounts of the distributive shares of the partners attributable to the calendar years 1918 and 1919 respectively the amounts subject to the rates for the calendar year 1919 shall be placed in the lower brackets of the rate schedule provided in the statute, and the amounts attributable to the calendar year 1918 in the next higher brackets of the rate schedule applicable to that year.[60]

Profits Earned Prior to March 1, 1913. In a case arising under the 1913 Law it was contended that where the fiscal year of a partnership ended between March 1, 1913, and December 31st of the same year, the equitable method would be to apportion the profits for the fiscal year in equal monthly instalments and allot to the period preceding March 1st its proper proportion, making the partners taxable only on their respective shares in the remainder. The court held that the plaintiff in this case failed to show that profits were earned by the partnership prior to March 1, 1913, and in what sum, and in the absence of such showing the court assumed that the tax was legally collected.[61] The Treasury Department held under the 1913 Law that the entire amount of profits accruing to a partner at the close of the fiscal year of the partnership were taxable in the calendar year in which the fiscal year ended,[62] although a part of the fiscal year may have covered a period prior to the incidence of the tax.

Net Losses of Partnership. Where the result of partnership operation is a net loss, the loss will be divisible between the partners in the same proportion as net income would have been divisible, and may be used by the indi-

60 Reg. 45, Arts. 323 and 1621. Revenue Act of 1918, §§ 205 (c), 206, 211 and 212.

61 Cohen v. Lowe, 234 Fed. 474.

62 T. D. 2090.

vidual partners in their returns of income,[63] as the loss of a partnership is considered to be a loss sustained in trade by the individual members. The partner may deduct the loss whether he is compelled to make good his proportionate share by payment of money to the partnership or whether the loss is charged against profits accrued to his account in preceding years.[64] If the loss occurs in a fiscal year covering a period in which there is a change of tax rates it does not seem that the loss should be pro-rated although the income if any would be, since a loss is deductible in the year in which it is actually sustained.[65]

Returns by Partnerships. Every partnership is required to make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by the law, and to include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return should be sworn to by any one of the partners.[66]

Returns of Tax Withheld at Source. Partnerships are required to make returns on or before March first of each

63 Reg. 33 Rev., Art. 30.

64 Letter from Treasury Department dated February 12, 1915; I. T. S. 1918, ¶ 674.

65 See Chapter 30 on Losses.

66 Revenue Act of 1918, § 224. Prior to the enactment of this provision partnerships as such were not required to render annual returns of income, but when requested by the Commissioner, or any collector, were required to make a correct return of earnings, profits and income, showing the gross income and the deductions and credits allowed by the law and the names and addresses of the individuals who would be entitled to the net earnings, profits and income if distributed. It was not required in such returns that the partnership report income exempt under § 4 of the 1916 Law. (Revenue Act of 1916, § 8 (e); Reg. 33 Rev., Art. 30; Reg. 33, Art. 12.) Special returns from partnerships were required generally in 1913, but no returns were required for the year 1914 or for subsequent years, except in instances where it was specially requested by the Commissioner of Internal Revenue or a collector. In 1917 partnerships were required to file returns of income for the excess profits tax.

year of amounts of tax required to be withheld at the source.[67]

RETURNS OF INFORMATION. Partnerships are required to file such returns as are required under the provisions of law relating to information at the source.[68]

REPORTS BY BROKERS. Every partnership and every personal service corporation doing business as a broker is required, when called upon by the Commissioner of Internal Revenue, to make a return showing the names of its customers with such details as to the profits, losses or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner of Internal Revenue to determine whether all income tax due on the profits or gains of such customers has been paid.[69] This report is for the purpose of information at the source and is more fully discussed in another chapter.[70]

Penalties. Partnerships or their members or employees are subject in certain cases to penalties, both specific and *ad valorem*, for failing or refusing to make returns, supply information, pay or collect any tax or for wilfully attempting in any manner to defeat or evade the income tax. Such penalties are more particularly discussed in another chapter.[71]

Examination of Partnership Records. All partnership books, papers, records or memoranda are subject to examination by any revenue agents or inspectors designated by the Commissioner of Internal Revenue for the purpose of ascertaining the correctness of returns which have been made, or making a return where none has been made, in accordance with and subject to rules which are discussed at length in another chapter.[72]

[67] Revenue Act of 1918, §§ 221 (c) and 237. See Chapter 40 on Collection of the Tax at the Source.

[68] Revenue Act of 1918, § 256.

[69] Revenue Act of 1918, § 255.

[70] See Chapter 39 on Information at the Source.

[71] See Chapter 36 on Penalties and Compromises.

[72] See Chapter 37 on Examination of Taxpayer's Books.

Personal-Service Corporations. Personal-service corporations are corporations whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, or any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits, or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.[73] Personal service corporations as such, are not subject to income tax, the individual stockholders thereof being taxed in the same manner as the members of partnerships, unless they make returns for fiscal years beginning in 1917.[74] All the provisions of law discussed in this chapter relating to partnerships and the members thereof apply, so far as practicable, to personal service corporations and the stockholders thereof, provided, that in the case of any personal-service corporation any amounts distributed during its taxable year shall be accounted for by the distributees (i. e. the persons who actually received the dividends); and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares.[75] Thus, the individual stockholders of personal service corporations are taxable upon their distributive shares in the same manner as the members of partnerships, but the corporation is subject to neither income nor excess profits taxes.[76]

Definition. The statutory definition of personal service corporations has been given above. By regulation the term

[73] Revenue Act of 1918, § 200.
[74] Reg. 45, Art. 324.
[75] Revenue Act of 1918, § 218 (e).
[76] Reg. 45, Art. 324.

"personal-service corporation" is defined as a corporation, not expressly excluded, the income of which is derived from a profession or business (a) which consists principally of rendering personal service, (b) the earnings of which are to be ascribed primarily to the activities of the principal owners or stockholders, and (c) in which the employment of capital is not necessary or is only incidental. No definite and conclusive tests can be prescribed by which it can be finally determined in advance of an examination of the corporation's return whether or not it is a personal-service corporation. The general principles under which such determination will be made are stated below. The following classes of corporations are expressly excluded from classification as personal-service corporations: (a) foreign corporations; (b) corporations 50 per cent. or more of whose gross income consists of gains, profits or income derived from trading as a principal; and (c) corporations 50 per cent. or more of whose gross income consists of gains, profits, commissions, or other income derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, inclusive. In order that a corporation may be deemed to be a personal-service corporation its earnings must be derived principally from compensation for personal services rendered by the corporation to the persons with whom it does business. Merchandising or trading either directly or indirectly in commodities or the services of others is not rendering personal service. Conducting an auction, agency, brokerage, or commission business strictly on the basis of a fee or commission is rendering personal service. If, however, the corporation assumes any such risks as those of market fluctuation, bad debts, failure to accept shipments, etc., or if it guarantees the accounts of the purchaser or is in any way responsible to the seller for the payment of the purchase price, the transaction is one of merchandising or trading and this is true even though the goods are shipped directly from the producer to the consumer and are never actually in the possession of the corporation. The fact

that earnings of the corporation are termed commissions or fees is not controlling. The fact that a commission or fee is based on a difference in the prices at which the seller sells and the buyer buys raises a presumption that the transaction is one of merchandising or trading, and it will be so considered in the absence of satisfactory evidence to the contrary. It frequently happens that corporations are engaged in two or more professions or businesses which are more or less related, one of which does not consist of rendering personal service. Thus an engineering concern may also engage in contracting, which amounts to trading in materials and labor, a brokerage concern may guarantee some of its accounts, a photographer may sell pictures, frames, art goods, and supplies, or a dealer in a commodity may furnish expert advice or services with respect to its installation, use, etc. In such case the corporation is not a personal service corporation unless the non-personal service element is negligible or merely incidental and no appreciable part of its earnings are to be ascribed to such sources. In determining whether a corporation is a personal-service corporation, no weight can be given to the fact that it renders personal services unless (a) the principal owners or stockholders are regularly engaged in the active conduct of its affairs and are engaged in such a manner that the earnings are to be ascribed primarily to their activities, and (b) its affairs are conducted principally by such owners or stockholders. Where the principal owners or stockholders do not render the principal part of the services, but merely supervise or direct a force of employees, the corporation is not a personal-service corporation. If employees contribute substantially to the services rendered by a corporation, it is not a personal-service corporation unless in every case in which services are so rendered the value of and the compensation charged for such services are to be attributed primarily to the experience or skill of the principal owners or stockholders and such fact is evidenced in some definite manner in the normal course of the profession or business. The fact that the principal

owners or stockholders give personal attention or render valuable services to the corporation as a result of which its earnings are greater than those of a corporation engaged in a like or similar business, the principal owners or stockholders of which do not devote personal attention to the management or supervision of its affairs, does not of itself constitute the corporation a personal-service corporation. No definite percentage of stock or interest in the corporation which must be held by those engaged in the active conduct of its affairs in order that they may be deemed to be the principal owners or stockholders can be prescribed as a conclusive test, as other facts may affect any presumption so established. No corporation or its owners or stockholders shall, however, make a return in the first instance on the basis of its being a personal-service corporation unless at least 80 per cent. of its stock is held by those regularly engaged in the active conduct of its affairs. The fact that the owners or stockholders of the corporation may change during the course of the taxable year does not take a corporation which is normally in the personal-service class out of that class. Frequent changes in the ownership of any substantial interest or number of shares is, however, evidence bearing on the question as to whether the principal owners or stockholders are actively engaged in the conduct of the affairs of the corporation. The incapacity, retirement or death of a principal owner or stockholder who has been actively engaged in the conduct of its affairs will not be deemed to make any change in the status of the corporation during a reasonable time thereafter. In determining whether a corporation is a personal-service corporation, no weight can be given to the fact that the invested capital for purposes of the war-profits and excess-profits tax or the actual investment of the principal owners or stockholders is comparatively small. The test established by the statute with respect to capital is entirely different. That test is the nature of the profession or business as indicated (a) by the kind of services it renders and (b) the extent to which capital is required to carry on such

profession or business. If the use of capital is necessary or more than incidental, capital is a material income-producing factor and the corporation is not a personal-service corporation. No corporation is a personal-service corporation if it carries on business of a kind which ordinarily requires the use of capital, irrespective of whether the owners or stockholders have actually invested a substantial amount of capital. The term "capital" means not only capital actually invested by the owners or stockholders, but also capital secured in other ways. Thus if capital is borrowed either directly as shown by bonds, debentures, certificates of indebtedness, notes, bills payable or other paper, or indirectly as shown by accounts payable or other forms of credit, or if the business of the corporation is in any way financed by or through any of the owners or stockholders, these facts will be deemed evidence that the use of capital is necessary. If a substantial amount of capital is used to finance or carry the accounts of clients or customers, it will be inferred that because of competition or other reasons such practice is necessary in order to secure or hold business which otherwise would be lost, and that the corporation is not a personal-service corporation. If a corporation engaged in an agency, brokerage, or commission business regularly employs a substantial amount of capital to lend to principals, to buy and carry goods on its own account, or to buy and carry odd lots in order that it may render more satisfactory service to its principals or customers, it is not a personal-service corporation. In general the larger the amount of the capital actually used the stronger is the evidence that capital is necessary and is a material income-producing factor and that the corporation is not a personal-service corporation.[77]

DIVIDENDS. In the case of personal-service corporations the term dividend means any distribution made by a personal-service corporation to its shareholders or members whether in cash or in property or in stock of the corporation

77 Reg. 45, Arts. 1523 and 1532.

out of its earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.[78] Any distribution is deemed to have been made from earnings or profits unless all earnings and profits have first been distributed. Any distribution made in the year 1918 or any year thereafter will be deemed to have been made from the most recently accumulated earnings or profits; but any earnings or profits accumulated prior to March 1, 1913, may be distributed in stock dividends, or otherwise, exempt from tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.[79]

Returns of Personal-Service Corporations. Every personal-service corporation must make a return of income, regardless of the amount of its net income. The return shall be on Form 1065 (revised). It shall be made for the taxable year of the personal-service corporation; that is, for its annual accounting period (fiscal year or calendar year, as the case may be), regardless of the taxable years of its stockholders. If the personal-service corporation makes any change in its accounting period it shall render its return in accordance with the provisions of Section 226 of the statute. The return of a personal-service corporation shall state specifically (a) the items of its gross income enumerated in Section 213 of the statute; (b) the deductions enumerated in Section 214 of the statute, other than the deduction provided in paragraph (11) of subdivisions (a) of that section; (c) the amounts specified in subdivisions (a) and (b) of Section 216 of the statute received by the personal-service corporation; (d) the amount of any income, war-profits and excess-profits taxes of the personal-service corporation paid during the taxable year to a foreign country or to any possession of the United States, and the amount of any such taxes accrued but not paid during the taxable year; (e) the amounts distributed

[78] Revenue Act of 1918, § 200 (a). See Chapter 23 on Income from Dividends.

[79] Revenue Act of 1918, § 200 (b). See Chapter 23 on Income from Dividends.

by the corporation during its taxable year with the dates of distribution; (f) the names and addresses of the stockholders of the corporation at the close of its taxable year and their respective shares in such corporation; (g) such facts as tend to show whether or not the corporation is a personal-service corporation; and (h) such other facts as are required by the form. A personal-service corporation which makes a return for a fiscal year beginning in 1917 shall include therein all the facts required for the computation of income and excess-profits taxes under Title I of the Revenue Act of 1916, as amended by the Revenue Act of 1917, and under Titles I and II of the Revenue Act of 1917.[79a]

PERSONAL-SERVICE CORPORATIONS MAKING RETURN ON CALENDAR YEAR BASIS. Personal-service corporations making returns on the calendar year basis are not subject to taxation as corporations under the statute. The individual stockholders are, however, subject to taxation (a) upon their distributive share of the net income of the corporation for its taxable year whether distributed or not, and (b) upon the earnings or profits of the corporation accumulated since February 28, 1913, and prior to January 1, 1918, distributed during such taxable year. The net income of a personal-service corporation is computed, as in the case of a partnership, in the same manner and on the same basis as is provided for the computation of the net income of an individual except that the deduction of certain kinds of contributions or gifts allowed individuals shall not be permitted.[80]

TAXATION OF STOCKHOLDERS OF PERSONAL-SERVICE CORPORATIONS WITH CALENDAR YEAR. A stockholder of a personal service corporation at the close of the calendar year 1918, and any subsequent calendar year, is required to account for and is taxable upon his proportionate share of the net income of the corporation for such taxable year

79a Reg. 45, Arts. 624, 1621-1625 and 951.

80 Reg. 45, Arts. 325, 1541, 1542. Revenue Act of 1918, §§ 201, 212, 214, 215.

which remains undistributed at that time. A stockholder who receives any amount in distribution of the net income of the corporation accumulated since December 31, 1917, which has not been accounted for by a stockholder as undistributed income is required to account therefor and is taxable thereon. A stockholder who receives any amount in distribution of earnings or profits of the corporation accumulated since February 28, 1913, and prior to January 1, 1918, is required to account therefor and is taxable thereon; but he is not required to account for any earnings or profits accumulated prior to March 1, 1913.[81]

PERSONAL-SERVICE CORPORATIONS MAKING RETURN FOR FISCAL YEAR BEGINNING IN 1917 AND ENDING IN 1918. If the fiscal year of a personal-service corporation began in the calendar year 1917 and ended in the calendar year 1918, it is, as a corporation, subject to income and excess-profits taxes for the part of such fiscal year which falls within the calendar year 1917. The amounts for which such a corporation is liable are such proportions respectively of the income taxes for the entire fiscal year, computed in accordance with Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917 and with Title I of the Revenue Act of 1917, and of the excess-profits taxes computed in accordance with Title II of the Revenue Act of 1917 for the entire fiscal year, as the portion of such fiscal year falling within the calendar year 1917 is of the entire period. Amounts previously paid by the corporation on account of income taxes for such fiscal year shall be credited toward the payment of the income taxes for the portion of the fiscal year falling within the calendar year 1917. Any excess will be credited or refunded in accordance with the provisions of Section 252 of the statute. Amounts previously paid by the corporation on account of excess-profits taxes for any period beginning on or after

[81] Reg. 45, Arts. 326, 1541, 1542, Revenue Act of 1918, § 201.

January 1, 1918, shall be immediately refunded as a tax erroneously or illegally collected.[82]

TAXATION OF STOCKHOLDERS OF PERSONAL-SERVICE CORPORATION WITH FISCAL YEAR ENDING IN 1918. An individual stockholder of a personal service corporation with a fiscal year ending in 1918, is, moreover, subject to taxation (a) upon his distributive share of the net income of the corporation for its fiscal year whether distributed or not, and (b) upon the earnings or profits of the corporation accumulated since February 28, 1913, and prior to the beginning of such fiscal year, distributed during such fiscal year. Such part of a stockholder's distributive share of the net income of a corporation for its fiscal year as is attributable to the calendar year 1918 is taxable at the rates for such calendar year, and such part of such distributive share as is attributable to the calendar year 1917 is taxable at the rates for such calendar year, but is not subject to normal tax. The part of a stockholder's distributive share of the net income of a corporation for its fiscal year attributable to the calendar year 1918 is found by determining his distributive share of the net income of the corporation for its fiscal year, whether distributed or not, in the same manner as if the fiscal year were the calendar year 1918, and then taking the proportion thereof which the part of such fiscal year falling within such calendar year bears to the full fiscal year. The part of a stockholder's distributive share of the net income of a corporation for its fiscal year attributable to the calendar year 1917 is found by determining the net income of the corporation for its fiscal year in accordance with the law applicable to the calendar year 1917 and determining the stockholder's distributive share thereof by adding to the amounts of such net income distributed to him during such fiscal year his proportion of the net income of such fiscal year remaining undistributed at the close thereof, and then taking the proportion of such distributive share which

[82] Reg. 45, Arts. 327, 1034, 1035, 1621. Revenue Act of 1918, §§ 205, 252, 335.

the part of such fiscal year falling within the calendar year 1917 bears to the full fiscal year.[83]

APPLICATION OF DIFFERENT TAX RATES IN THE CASE OF FISCAL YEAR ENDING IN 1918. Any deductions, exemptions, or credits to which the stockholder of a personal service corporation with a fiscal year ending in 1918 is entitled shall first be applied against his income subject to the rates for the calendar year 1918, unless of a kind plainly and properly chargeable against income taxable at the rates for the calendar year 1917. The proportionate share of a stockholder of any excess profits tax imposed upon the corporation under the Revenue Act of 1917 with respect to that part of the fiscal year falling within the calendar year 1917, is plainly and properly chargeable against income taxable at the rates for that year and shall be credited against such income of the stockholder. In determining the rates of tax applicable to the amounts of the distributive shares of the stockholders attributable to the calendar years 1917 and 1918, respectively, the amounts subject to the rates for the calendar year shall be placed in the lower brackets of the rate schedule provided in the present statute, and the amounts attributable to the calendar year 1917 in the next higher brackets of the rate schedule applicable to that year.[84]

PERSONAL-SERVICE CORPORATION MAKING RETURN FOR FISCAL YEAR ENDING IN 1919 OR LATER. If the fiscal year of a personal-service corporation began in the calendar year 1918 or later and ends in the calendar year 1919 or later, it is not subject to taxation as a corporation under the statute. An individual stockholder is, however, subject to taxation (a) upon his distributive share of the net income of the corporation for its fiscal year whether distributed or not, and (b) upon the earnings or profits of the corporation accumulated since February 28, 1913, and

[83] Reg. 45, Arts. 328, 1541, 1542. Revenue Act of 1918, §§ 201, 205.

[84] Reg. 45, Arts. 329, 1641. Revenue Act of 1918, § 206.

prior to January 1, 1918, distributed during such fiscal year.[85]

TAXATION OF STOCKHOLDERS OF PERSONAL-SERVICE CORPORATION WITH FISCAL YEAR ENDING IN 1919. Such part of a stockholder's distributive share of the net income of a personal-service corporation for its fiscal year ending in 1919 as is attributable to the calendar year 1919 is taxable at the rates for such calendar year, and such part of such distributive share as is attributable to the calendar year 1918 is taxable at the rates for such calendar year. The part of a stockholder's distributive share of the net income of a corporation for its fiscal year attributable to the calendar year 1919 is found by determining his distributive share of the net income of the corporation for its fiscal year, whether distributed or not, in the same manner as if the fiscal year were the calendar year 1919, and then taking the proportion thereof which the part of such fiscal year falling within such calendar year bears to the full fiscal year. The part of a stockholder's distributive share of the net income of a corporation for its fiscal year attributable to the calendar year 1918 is found by determining his distributive share of the net income of the corporation for its fiscal year, whether distributed or not, in the same manner as if the fiscal year were the calendar year 1918, and then taking the proportion thereof which the part of such fiscal year falling within such calendar year bears to the full fiscal year.[86]

APPLICATION OF DIFFERENT TAX RATES IN THE CASE OF FISCAL YEAR ENDING IN 1919. Any deductions, exemptions, or credits to which the stockholder of a personal service corporation with a fiscal year ending in 1919 is entitled shall first be applied against his income subject to the rates for the calendar year 1919, unless of a kind plainly and properly chargeable against income taxable at the rates for the calendar year 1918. In determining

85 Reg. 45, Arts. 330, 1541, 1542. Revenue Act of 1918, § 201.
86 Reg. 45, Arts. 331, 1621. Revenue Act of 1918, § 205.

the rates of tax applicable to the amounts of the distributive shares of the stockholders attributable to the calendar years 1918 and 1919, respectively, the amounts subject to the rates for the calendar year 1919, shall be placed in the lower brackets of the rate schedule provided in the statute and the amounts attributable to the calendar year 1918 in the next higher brackets of the rate schedule applicable to that year.[87]

CREDITS ALLOWED STOCKHOLDERS OF PERSONAL-SERVICE CORPORATIONS. A stockholder of a personal-service corporation is entitled to credit, for the purpose of the normal tax only, for amounts received in distribution of earnings or profits of the corporation accumulated since February 28, 1913, and prior to January 1, 1918, or, in the case of a personal-service corporation with a fiscal year ending in 1918, prior to the beginning of the fiscal year. In addition to the credits ordinarily allowed to an individual, a stockholder of a personal-service corporation is entitled to the following credits: (a) a credit against net income for the purpose of the normal tax only of his proportionate share of such dividends from a corporation subject to tax and of such interest not entirely exempt from tax upon obligations of the United States and bonds of the War Finance Corporation as are received by the personal-service corporation, and (b) a credit against income tax of the stockholder's proportionate share of income, war-profits, and excess-profits taxes of the personal-service corporation paid or accrued during the taxable year to a foreign country upon income derived from sources therein, or to any possession of the United States.[88]

CORPORATIONS FORMED TO EVADE THE SURTAXES. If any corporation, however created or organized, is formed or availed or for the purpose of preventing the imposition of the surtax upon its stockholders or members through the

[87] Reg. 45, Arts. 332, 1641. Revenue Act of 1918, § 206.

[88] Reg. 45, Arts. 333, 301, 381, 384, 1541. Revenue Act of 1918, §§ 201, 216, 222.

medium of permitting its gains and profits to accumulate, instead of being divided or distributed, the stockholders of such corporation will be subject to income tax in the same manner as the stockholders of a personal-service corporation.[89]

[89] Revenue Act of 1918, § 220. For a full discussion of this subject see Chapter 2 on the Income Tax Rates.

CHAPTER 11

FOREIGN PARTNERSHIPS

The 1916 Law expressly mentioned foreign partnerships in only one provision,[1] that which required the withholding of the tax on payments of income from interest upon bonds and mortgages or deeds of trust or similar obligations of domestic or other resident corporations, to non-resident alien firms and copartnerships not engaged in business or trade within the United States and not having any office or place of business therein. The Revenue Act of 1918 defines the term "foreign" when applied to a partnership as meaning "created or organized outside the United States,"[2] but does not use the word "foreign" in connection with partnerships in the part of the Act imposing the income tax. The Act, however, provides that individuals carrying on business in partnership shall be liable for income tax in their individual capacity and this implies that the income of a foreign partnership from sources within the United States is taxable in the hands of the non-resident alien partners, to the extent included in the distributive share of each and such has been the ruling of the Treasury Department.[3] The income received by

1 Revenue Act of 1916, § 13 (e).

2 Revenue Act of 1918, § 200. Under the regulations a foreign partnership is one created or organized outside the United States including only the States, the Territories of Alaska and Hawaii, and the District of Columbia. (Reg. 45, Art. 1508.) The term "foreign" is applied to partnerships in the title imposing Stamp Taxes. (Revenue Act of 1918, § 1107, Schedule A-15.)

3 Letter from Treasury Department dated April 7, 1917; I. T. S. 1918, ¶ 702. Letter from Treasury Department dated June 6, 1918;

a non-resident alien partnership from sources within the United States does not, like the income received by a domestic or resident alien partnership lose its identity as to source when distributed to a non-resident alien member of a firm.[4] If the partner is a citizen or resident of this country, he is of course subject to tax upon his entire distributive share of the profits of any partnership of which he may be a member.

Definition. In the 1916 Law the phrase "alien partnership" was used, but no definition of the term was given in the law or was to be found in the regulations. The 1916 Law also referred to "non-resident alien firms" and to "non-resident alien copartnerships" synonymously, and applied the terms without regard to whether or not the firm or copartnership was engaged in business or trade within the United States or had an office or place of business in this country. The term may be argued to have had reference to the status of the partners composing the firm, and in this respect it was indefinite, as a firm may be composed of non-resident aliens and resident aliens or citizens.[5] For the sake of clearness in discussing the subject of this chapter, the term "foreign partnership" as used herein is defined as a partnership or firm, whether composed of aliens or citizens, residents or non-residents, which has its principal place of business in a foreign country and directs all or the principal part of its business from its office outside the jurisdiction of the United States.

I. T. S. 1918, ¶ 3528. Letter from Treasury Department dated October 1, 1918; I. T. S. 1918, ¶ 3641.

[4] Letter from Treasury Department dated October 1, 1918; I. T. S. 1918, ¶ 3641.

[5] Under the present law a foreign partnership is defined as indicated in note 2. The nationality or residence of the members of a partnership does not affect its status. Thus a partnership created by articles entered into in San Francisco between residents of the United States and residents of China is held to be a *domestic* partnership. (Reg. 45, Art. 1508.) According to the definition in the statute and regulations, a partnership composed entirely of citizens

Limited Partnerships. If the foreign partnership is one of the kind which, if it were domestic, would be treated as a corporation or association,[6] it seems that it should report its net income and pay the tax according to the provisions of the law and regulations applicable to foreign corporations. Having done so, its partners should treat their net distributive shares of the profits as dividends. Since non-resident alien stockholders of a non-resident foreign corporation are not taxable to any extent on the dividends of such corporation, it would follow that the partners of a non-resident foreign partnership or association which is required by the regulations to report and pay the tax as a corporation, would not be subject to any tax on their net distributive shares of the profits.

General Partnerships. If the foreign partnership is a general partnership,[7] not having the characteristics which would require it to pay the tax in the manner of corporations, it is not, itself, subject to the tax on income derived from sources within this country, but each of its individual members is subject to the tax on such part of his distributive share of the partnership profits as is composed of income from this country.[8]

RESIDENT FOREIGN PARTNERSHIPS. A foreign partnership which is engaged in business or trade within the United States and has an office or place of business herein is a resident foreign partnership.

NON-RESIDENT FOREIGN PARTNERSHIPS. A non-resident foreign partnership is defined as a foreign partnership

and residents and doing all its business here would be a "foreign" partnership if created by articles entered into in a foreign country. The intention of the parties as to the place where the principal business is to be carried on (which is best evidenced by the subsequent acts of the partnership) is a sounder basis for a distinction between domestic and foreign partnerships.

[6] See the discussion of Limited Partnerships in the preceding chapter.

[7] See discussion of General Partnerships in the preceding chapter.

[8] Letter from Treasury Department dated December 6, 1916; I. T. S. 1918, ¶ 703.

which does not have any office or place of business within the jurisdiction of the United States.

Collection of the Tax at the Source. A non-resident partnership is not subject to having any tax withheld at the source on income from sources in this country, except in the case of bonds of corporations containing covenants to pay the tax. The Treasury Department under the 1916 Law made no distinction based upon the status of the individual partners and no such distinction is made under the present law.[9]

Non-Resident Foreign Partnerships. Under the 1916 Law non-resident foreign partnerships were not subject to having the tax withheld on interest from investments in the bonds or similar obligations of domestic or resident corporations,[10] or on dividends[11] on the stock of corporations or other income. Under the Revenue Act of 1918

9 Telegram from Treasury Department dated May 17, 1918; I. T. S. 1918, ¶ 3362. It is interesting to note in this connection that immediately after the 1913 Law was enacted and before it was held that partnerships were not subject to withholding, the Treasury Department provided for the use of partnerships an ownership certificate which required a statement of the names and addresses of each of the partners. No such disclosure of the names of the partners of non-resident foreign partnerships was subsequently required, which indicates that the Treasury Department did not consider the individual status of the partners to be essential in determining whether or not withholding is necessary.

10 Telegram from Treasury Department dated May 17, 1918; I. T. S. 1918, ¶ 3362. The language of the Revenue Act of 1916, § 13 (e) as amended, was ambiguous. It provided that the provisions relating to withholding of the tax should be made applicable "to the tax imposed by Subdivision (a) of § 10 upon incomes derived from interest upon bonds and mortgages or deeds of trusts or similar obligations of domestic or other resident corporations * * * by non-resident alien firms." No tax, as a matter of fact, was imposed upon firms or partnerships by Subdivision (a) of § 10, and consequently it was ruled that no tax need be withheld.

11 Reg. 33 Rev., Art. 32. Letter from Treasury Department dated June 6, 1918; I. T. S. 1918, ¶ 3528.

they will be subject to having the tax withheld only on interest from so-called tax-free covenant bonds.[12]

RESIDENT FOREIGN PARTNERSHIPS. Withholding was not required in any case on payments to a resident foreign partnership under the 1916 Law. For the purpose of establishing its identity and status, a form was provided which might be used to accompany coupons from bearer bonds in order to claim exemption from withholding at the source.[13] Under the Revenue Act of 1918 withholding will be required against resident foreign partnerships only in the case of interest from so-called tax-free covenant bonds.[14]

Agents for Foreign Partnerships. A resident of this country might for the purpose of the 1916 Law occupy the position of an agent for a foreign partnership and in connection therewith be subject to the duties of resident agents as indicated in the chapter on that subject.[15]

Nominal Stockholders. Under the 1916 Law if a foreign partnership was the actual owner of stock of domestic or resident corporations, the partners thereof were subject to the surtax (but not the normal tax) to the same extent as other individuals. The Income Tax Law did not require withholding of the tax from dividends, whether paid direct to a non-resident foreign partnership or through a nominal stockholder. Where the non-resident foreign partnership was the actual owner, and a resident of this country was the nominal holder of the stock, the latter was required to make disclosure of the actual owner by filing a certificate of actual ownership with the Commissioner of Internal Revenue for the information of the collector. No return was required to be made and no amount retained unless the nominal stockholder was so

12 Revenue Act of 1918, § 221 (b); Reg. 45, Art. 361. See Chapter 40 on Collection at the Source.

13 The form used under the 1916 Law was Form No. 1001; Reg. 33 Rev., Art. 43. Telegram from Treasury Department dated May 21, 1918; I. T. S. 1918, ¶ 3364. See I. T. S. 1918, ¶ 3452a.

14 Revenue Act of 1918, § 221 (b); Reg. 45, Art. 361.

15 See Chapter 6 on Resident Agents.

requested.[16] If a non-resident foreign partnership was a nominal stockholder, a certificate disclosing the actual ownership was executed and forwarded to the Collector of Internal Revenue at Baltimore, Maryland, in order that the members of the partnership might avoid any liability for tax because of the apparent ownership of such stock.[17] Income received as dividends from a corporation taxable upon its net income is no longer subject to withholding;[18] nevertheless dividends on stock of domestic corporations or resident foreign corporations are *prima facie* income to the record owners of the stock and such record owner will be liable for any surtax thereon unless a disclosure is made as set forth elsewhere in this book.[19]

Procedure in Collecting Income. In collecting income from interest on bonds not containing a tax-free covenant a resident or non-resident foreign partnership makes use of a form certifying that it is not subject to having the income tax withheld at the source.[20] In collecting any other form of income no prescribed certificate is necessary, but the partnership might be called upon to disclose its name and location for the purpose of supplying the payor of the income with the information which he is required to transmit to the Government.

Duty in Paying Out Income. Resident foreign partnerships are under the same duty in paying out income to others as are domestic partnerships; that is, they are required to withhold on payments made from the office in this country under the same conditions as would require domestic partnerships to withhold. They are also required to report the names of those to whom they pay fixed or determinable income, in the manner required by law of

16 Reg. 33 Rev., Art. 32.

17 Reg. 33 Rev., Art. 32.

18 Revenue Act of 1918, § 221 (a); Reg. 45, Art. 362. See Chapter 40 on Collection of the Tax at the Source.

19 Reg. 45, Art. 404. See Chapter 7.

20 Reg. 45, Art. 365. Form No. 1001 (revised) is used for this purpose.

corporations, partnerships and individuals generally.[21]

Extent to Which Taxable. Foreign partnerships, unless they are of the kind taxable as corporations,[22] are not taxable, but the partners are required to pay the tax in all cases on their distributive shares of the profits, gains or income arising from sources within the United States. Thus, in the case of resident foreign partnerships, the income from the business transacted in the United States and from investments in this country is taxable. In the case of a non-resident foreign partnership, income from investments in this country and gains from the buying and selling of property of any kind in this country are taxable.[23] The law expressly provides that amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States are income from sources within the United States. Net income is ascertained under the rules applicable to non-resident alien individuals.[24]

Returns. Neither resident nor non-resident foreign partnerships were required to file returns for the taxable year under the 1916 Law. Partnerships are now required to file returns of income annually, but no regulations have yet been issued prescribing returns by non-resident foreign partnerships. A resident foreign partnership will probably be required to file a return similar to the return of domestic partnerships.[25]

21 See Chapters 39 and 40 on Information at the Source and Collection of the Tax at the Source.

22 See the discussion of Limited Partnerships in the preceding chapter.

23 Letter from Treasury Department dated December 6, 1916; I. T. S. 1918, ¶ 703.

24 Revenue Act of 1918, § 213 (c); Reg. 45, Art. 91. A further discussion of the term "sources within the United States" is contained in Chapter 5 on Non-Resident Aliens.

25 Revenue Act of 1918, § 224. Under the 1916 Law both resident and non-resident foreign partnerships might be called upon by the Commissioner to file special returns showing the net income from sources within this country and the distributive shares of the part-

Special Returns. Resident foreign partnerships are required to make returns reporting the amount of tax withheld at the source and the names and addresses of persons to whom fixed and determinable income has been paid and broker returns in the same manner and subject to the same conditions as domestic partnerships.[26]

Returns by Partners. The partners of foreign partnerships are required to make a return showing their own distributive shares of the income of the partnership from sources in this country on the same form as is used in reporting other income.[27] If a partner is a citizen or resident of this country he must, of course, include all of his income from the foreign partnership, but if he is a non-resident alien only so much as has been derived from sources within the United States. In making his personal return the partner will follow the procedure outlined for non-resident aliens or the procedure outlined for citizens and residents, as the case may be.

Foreign Items. Resident foreign partnerships undertaking as a matter of business and for profit the collection of foreign items are required to obtain a license in the same manner as domestic partnerships engaged in the same business.[28]

Penalties. Resident foreign partnerships or their members or employees are subject in certain cases to penalties both specific and *ad valorem* for failing or refusing to make returns, supply information, pay or collect any tax or for wilfully attempting in any manner to defeat or evade the income tax. Such penalties are more particularly discussed in another chapter.[29]

ners in such income, but such returns were not required to be filed unless the partnership was specifically requested to do so by the Commissioner.

26 Revenue Act of 1918, §§ 221 (c), 255, 256. See Chapter 39 on Information at the Source.

27 Form No. 1040 under the 1916 Law.

28 Revenue Act of 1918, § 259. See Chapter 39 on Information at the Source.

29 See Chapter 36 on Penalties.

CHAPTER 12

CORPORATIONS

Corporations are taxed as separate entities apart from their stockholders. They are subject to a tax of 12% upon their net income for the year 1918 and 10% upon their net income for the year 1919 and subsequent years.[1] This tax is in lieu of the taxes imposed by the 1916 Law[2] as amended by the 1917 Law.[3] The total tax to which corporations were subject under both the 1916 and the 1917 Laws was 6%. Corporations are not subject to the surtaxes.[4] They are entitled to deduct from their gross income, which (except in the case of insurance companies) is computed in the same manner as the gross income of individuals,[5] the deductions and credits specified in the law[6] which differ to some extent from the deductions and credits allowed to individuals. Corporations, like individuals, make returns for the calendar or their fiscal year, according to the annual accounting period employed in keeping their books.[7] The mere existence of a corporation during any part of the year is sufficient to require it to make a return.[8] Prior to the present law, the mere receipt of net

1 Revenue Act of 1918, § 230. Transportation systems are taxable as to part of this rate by amendment of the 1917 Law. See paragraph on Transportation Systems, post.

2 Revenue Act of 1916, § 10.

3 Revenue Act of 1917, § 4.

4 See Reg. 33, Art. 185.

5 Revenue Act of 1918, § 233.

6 Revenue Act of 1918, §§ 234 and 236.

7 Revenue Act of 1918, §§ 200 and 232.

8 T. D. 2090. Revenue Act of 1918, § 239.

income from any source made it liable for the tax, but it may now be in receipt of net income without being liable for the tax if the credits to which it is entitled equal or exceed such net income.[9] Thus, a corporation may be in receipt of net income not in excess of $2,000 and be entitled to a credit of $2,000 against such net income for the purpose of the income tax, as a result of which it will be in receipt of net income without being liable for the tax. Doing business is not a necessary element of taxability.[10] The tax is an income tax and not an excise tax.[11] Certain special provisions of the law applicable only to insurance companies are discussed in another chapter.[12]

Definitions. The tax is imposed on every corporation, domestic or foreign. The word "corporation" is used in this chapter as defined in the present law,[13] and includes associations, joint-stock companies, and insurance companies. As used in the regulations issued under the 1916 Law, the term "corporation" was construed to include all corporations, joint-stock companies and associations, and all insurance companies coming within the terms of the law as well as all business trusts organized or created for the purpose of engaging in commercial or industrial enterprises, the capital of which was evidenced by certificates or shares of interest issued or issuable to members on the basis of which profits were distributed or distributable.[14]

9 Revenue Act of 1918, §§ 234 and 236.

10 The numerous cases under the 1909 Law holding certain corporations not to be taxable on the ground that they were not "doing business" have no application to the *income* tax laws.

11 The tax assessed on corporations for the months of January and February, 1913, under the 1913 Law, was an excise tax and not an income tax and, therefore, applied only to corporations "doing business," but the exemptions and deductions to which a corporation was entitled were those allowed by the 1913 Law, which law did not permit the deduction of dividends. (Butterick Company v. U. S., 240 Fed. 539.)

12 See Chapter 13 on Insurance Companies.

13 Revenue Act of 1918, § 1.

14 Reg. 33 Rev., Art. 57.

JOINT-STOCK COMPANIES AND ASSOCIATIONS.[15] There seems to be no constitutional or legal objection to including joint-stock companies in the same category with corporations.[16] A joint-stock company organized pursuant to the New York Joint-Stock Association Law was held, under the 1909 Law, to be practically a "corporation,"

[15] The 1909 Law taxed "Every corporation, joint-stock company or association, organized for profit and having a capital stock represented by shares, and every insurance company, now or hereafter organized under the laws of the United States or of any State or Territory of the United States or under the Acts of Congress applicable to Alaska or the District of Columbia, or now or hereafter organized under the laws of any foreign country and engaged in business in any State of Territory of the United States or in Alaska or in the District of Columbia." (Act of August 5, 1909, § 38.) The 1913 Law taxed "Every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships." (Act of October 3, 1913, § G (a)). The 1916 Law taxed "Every corporation, joint-stock company or association, or insurance company organized in the United States, no matter how created or organized but not including partnerships." (Revenue Act of 1916, § 10 (a)). The 1918 Law taxes every corporation and defines the term "corporation" to include "associations, joint-stock companies, and insurance companies." (Revenue Act of 1918, § 1, 230.) It will be noted that the phrase "no matter how created or organized" used in both the 1913 and 1916 Laws is omitted from the definition of corporation contained in the 1918 Law. On the other hand, the phrase "joint-stock company or association" (between commas) has been changed to "associations, joint-stock companies." The purpose of this transposition is to separate the word "associations" from any limitation imposed by conjunction with the word "joint-stock" and to use it to cover organizations which cannot be included within the terms "corporations," "joint-stock companies," or "insurance companies." The phrase "no matter how created or organized" seems to have been aimed to include organizations not "organized *under the laws* of the United States or of any state * * *" which were held not liable to tax under the 1909 Law, in view of the language of that Act. See Eliot v. Freeman, 220 U. S. 178; T. D. 2418; Reg. 38 Rev., Art. 2, General Instructions 3; see also Chapter 46 on Capital Stock Tax.

[16] As to including such organizations in the provisions applicable to corporations, see Spreckels Sugar Refining Co. v. McClain, 192 U. S. 397; Flint v. Stone-Tracy Co., 220 U. S. 107.

despite the absence of the important corporate attribute of limited liability, and was held taxable as such.[17] It was held under the 1913 Law that an association formed as a partnership under the laws of Hawaii and having as its members a number of corporations was not a corporation. In the association involved in this case there were no special partners nor was there limited liability. The partnership arrangement lacked the element of changeability of membership or transferability of shares, an element often used as a determining criterion as between ordinary partnerships and joint-stock companies. In a joint-stock company the members have no right to decide what new members shall be admitted to the firm; on the other hand, such a right is an inherent quality of the ordinary partnership.[18] By regulation issued under the 1918 Law, it is provided that the terms "joint-stock companies" and "associations" include associations, common-law trusts, or organizations by whatever name known which carry on or do business in an organized capacity, whether created under and pursuant to State laws, trust agreements, declaration of trusts, or otherwise, the net income of which if any, was distributed or distributable among the members or shareholders on the basis of the capital stock which each holds, or where there is no capital stock, on the basis of the proportionate share or capital which each has, or has invested, in the business or property of the organization.[19]

"SYNDICATES" ARE NOT CORPORATIONS. Where a block of securities are purchased in joint account by several corporations, partnerships or individuals for the purpose of disposing of them to the public through the syndicate managers, the only obligation of the members of the syndicate being to take and pay for the portion of the securities not disposed of, such temporary combinations of business interests are neither corporations, joint-stock companies or

17 Roberts v. Anderson, 226 Fed. 7.

18 Haiku Sugar Co. v. Johnstone, 249 Fed. 103; Reg. 45, Art. 1503.

19 Reg. 45, Art. 1502; Reg. 33 Rev., Art. 58. See also Reg. 33, Art. 79.

associations, nor partnerships, within the meaning of the income tax law and the profits of the syndicate are not taxable in the hands of the syndicate. The several members pay the tax on their respective shares of the profit of the transaction.[20]

TRUSTS TAXABLE AS ASSOCIATIONS. In the case under the 1916 Law of a trust created to hold certain land and to dispose of the same and distribute the proceeds to the beneficiaries, the title stood in the names of the trustees who received and distributed moneys, and transacted all of the business connected with the management and control of the trust property. The pro-rata interests of the beneficiaries were represented by beneficial certificates issued to them by the trustees. These certificates could be transferred if the transferee executed and became a party to the original declaration of trust and articles of agreement. The purpose of the trust was to dispose of the land from time to time and pay the net proceeds over to the beneficiaries and the trustees had no power to carry on any other business. It was held that this trust partook of the character of an association and was subject to the tax as an entity.[21] In the case of a common-law trust created in Massachusetts before the passage of the 1913 Law, authorizing the trustees to collect the income from real estate and shares of stock in a Massachusetts corporation, the legal title of which real estate and stock was vested in the trustees, and to pay over to the beneficiaries such portion of the income received as the trustees might in their discretion determine to be fairly distributable net income, the beneficiaries being given no right to compel the trustees to pay over any sum whatever, it was held that the trustees, though not subject to taxation as partners, were an association, as their power resembled the power of directors of a corporation, and as the income of the trust could not be deemed income to the

20 Letter from Treasury Department dated February 25, 1916.
21 Letter from Treasury Department dated March 14, 1917.

beneficiaries until received by them.[22] Where, however, the interest of each beneficiary in the income of trust property, as received, belongs to him as his separate, individual property, and the trustee is required to make prompt distribution of it and is not responsible for the operation of the property from which it is derived, the trustee and *cestuis que trust* do not constitute an association.[23]

PRIVATE BANKS. A partnership bank conducted like a corporation and so organized that the interests of its mem-

[22] Crocker v. Malley, 250 Fed. 817. This case is No. 649 on the docket of the United States Supreme Court, a petition for a writ of certiorari having been granted on November 4, 1918. In the opinion of the Circuit Court of Appeals it was said in part: "However important it may be to distinguish between a trust under which there is no partnership relation among the beneficiaries, and an association under which such relation exists, for the purposes of systems of taxation such as that of Massachusetts (Williams v. Milton, 215 Mass. 1, 102 N. E. 355), or for the purposes of statutes such as that construed in Smith v. Anderson, 50 L. J. Ch. 39, it does not seem to us that the distinction so made necessarily excludes an organization like this from the general class of organizations to which the terms 'voluntary association' or 'association' may properly be applied. The holders of the assignable certificates representing the different beneficial interests in this 'trust' may certainly be described, without using language in any extraordinary or unusual sense, as associated together for their common benefit or profit. Their individual interests in the trust property are combined for the purposes of a joint business venture managed for the common benefit of all. The trust declaration in effect associates them for the purposes of allowing extra compensation to the trustees, of filling vacancies in the office of trustee, or of modifying the terms of the declaration itself, when it requires for those purposes written assent from a 'majority in amount' or a 'majority in interest.' Believing, in view of the entire scheme for taxation of incomes as established by this statute, that the legislative intent as to incomes such as these plaintiffs have received was to treat them as arising or accruing to the trustees collectively, rather than to the individual beneficiaries for whose ultimate benefit they were received, we are obliged to hold that the taxes for the years here in question were lawfully assessed and collected, and that the District Court erred in its decision to the contrary."

[23] Reg. 45, Art. 1504.

bers may be transferred without the consent of the other members is a joint-stock company or association within the meaning of the statute.[24] A partnership bank the interests of whose members can not be so transferred is a partnership.[25] A private bank owned by an individual is not an "association."

LIMITED PARTNERSHIPS. Under the 1916 Law limited partnerships—that is, partnerships having one or more special partners who might share in the profits of the firm but whose liability for the debts of the company was limited to the amount of capital invested by such partner or partners—were held broadly to be taxable as associations for purposes of the income, war-profits, excess-profits and capital stock tax.[26] But this rule was later modified and a distinction was made between limited partnerships of the New York, Illinois and California types and limited partnerships of the Pennsylvania type, the former being held to be partnerships and the old rule being continued as to the latter.[27]

Residence. A domestic corporation is one organized or created in the United States including only the states, the territories of Alaska and Hawaii and the District of Columbia. Domestic corporations are considered to be residents of this country whether or not their property and business are located within or without this country. A domestic corporation is taxable regardless of the fact that it might derive all of its income from sources outside of the United States,[28] but dividends on stock and interest

[24] Reg. 45, Art. 1503; T. D. 2137. Mimeograph Letter to Collectors, No. 1271, I. T. S. 1918, ¶ 663.

[25] Reg. 45, Art. 1505; Reg. 33 Rev., Art. 62; Reg. 33, Art. 86, January 5, 1914; T. D. 2137.

[26] Reg. 45, Art. 1506; T. D. 2711; Letter from Treasury Department dated May 4, 1918, I. T. S. 1918, ¶ 3355.

[27] See Chapter 10 on Partnerships.

[28] In a case under the 1909 Law payment of the tax was refused, the corporation claiming that because its business was transacted in a foreign country and it had no assets in this country, its stockholders living in the foreign country and its income being spent

on notes of domestic corporations which do no business and own no property in the United States, paid to nonresident aliens or corporations are held to be not subject to tax.[29] Under the present law, domestic corporations may credit against the amount of tax which would be due on income derived from all sources the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country upon income derived from sources therein, or to any possessions of the United States, provided they furnish satisfactory evidence showing the amount of income derived from sources within such foreign country or such possessions of the United States, as the case may be, and all other information necessary for the computation of such credit.[30]

CORPORATIONS DOING BUSINESS IN THE PHILIPPINES AND PORTO RICO. Under former income tax laws corporations doing business wholly in Porto Rico and the Philippines, even though incorporated in the United States, were held to be resident corporations of these possessions and were required to make return and pay the income tax to the collector of internal revenue having jurisdiction therein. If a corporation was resident in the United States, and was doing only a part of its business in Porto Rico and the Philippines, it was taxable only in the United States. A corporation organized under the laws of the United States (i. e. the federal laws) or under the local laws of these possessions and resident therein was required to pay the

and invested there, it was not liable for the tax assessed. The Treasury Department proposed to test the question, but after the institution of suit the Company abandoned its position and made payment covering the tax and penalties, the action being thereupon discontinued. (T. D. 1863.)

29 Reg. 45, Art. 92. This is the first ruling that has appeared on this point and is a departure from the position heretofore taken by the Treasury Department. It seems, however, that the ruling applies to situations under former laws as well as under the present law.

30 Revenue Act of 1918, § 238 (a).

tax in the possession in which it was resident.[31] Under the present law every corporation "created or organized in Porto Rico or the Philippine Islands, *or deriving income from sources therein,*" is taxable in those possessions in accordance with the provisions of the 1916 Law as amended. A corporation "created or organized outside Porto Rico or the Philippine Islands and *deriving income from sources therein*" is treated in those possessions as a foreign corporation. Thus, a corporation created or organized in the United States is a foreign corporation in the possessions of the United States, but it may credit the tax which would otherwise be payable to the United States on income derived from all sources, both within and without the United States, with the amount of tax which it has paid in Porto Rico or the Philippines, as the case may be, upon income derived from sources therein. This credit, like similar credits for all foreign taxes upon income derived from sources in foreign countries, will only be allowed if the corporation furnishes satisfactory evidence showing (a) the amount of income derived from sources within the possessions and (b) all other information necessary for the computation of the tax.[32]

Corporations Formed During the Year. A corporation organized during the year is required to make a return covering that portion of the year during which it was engaged in business or had income accruing to it.[33] The fact that a new corporation organized in the year has transacted no business does not excuse it from making a return.[34] Corporations which have applied for but not received charters, or corporations which have received charters but have not perfected their organizations, transacted no business and had no income whatever from any source, may upon the presentation of these facts to the local collector be relieved from the necessity of making

[31] T. D. 2090.
[32] Revenue Act of 1918, §§ 261 and 238.
[33] Reg. 33, Art. 84; Reg. 45, Art. 621.
[34] T. D. 2090. Reg. 45, Art. 621.

returns so long as they remain in this unorganized condition.[35] When a distinct new corporation is organized to take over the property of an old corporation, both corporations will be required to make returns covering the periods of the year during which they were each respectively in charge of the business, or file a consolidated return.[36]

Corporations Merging During the Year. In case of a merger or consolidation of two or more corporations during the year, it was held under the 1909 Law that each corporation was required to make a return of the income received during the year prior to the date of merger and consolidation,[37] but under the present law it seems in such case a consolidated return would account for all the income of the year.

Change of Name. A mere change in name does not constitute a new corporation. If the business was continuous throughout the year, no change in management or operation other than the change in name having occurred, the return should be made covering the business transacted throughout the year, such returns to be made by the corporation in the name which it bears at the end of the year, with a notation on the return to the effect that the name had been changed, giving both the old and the new names.[38]

Corporations Liquidating During the Year. Under the 1916 Law it was held that a corporation going into liquidation during any tax period could at the time of such liquidation prepare a "final return" covering the income received or accrued to it during the fractional part of the fiscal or calendar year during which it was engaged in business, and immediately file it with the local collector.[39]

[35] T. D. 2152. Reg. 45, Art. 621.

[36] Reg. 33 Rev., Art. 206; T. D. 2137.

[37] T. D. 1675.

[38] Reg. 33 Rev., Art. 206; T. D. 2137.

[39] Reg. 33 Rev., Art. 205. See Reg. 33, Art. 85; T. D. 2209, T. D. 2090. It was held on demurrer under the Corporation Excise Tax Law of 1909 that a corporation could not evade liability for the

Under the present law it seems to be within the power of the Commissioner of Internal Revenue to declare the taxable period of a corporation terminated at the end of the calendar month preceding the month in which it is dissolved and to demand immediate payment of the tax for such taxable period and the tax for the preceding year or to require security for the payment thereof.[40] This remedy is more fully discussed elsewhere in this book.[41] Where a corporation, by affidavit or otherwise, has clearly established the fact and satisfied the collector of internal revenue that it is defunct, dissolved or obsolete and is no longer carrying on business and has no property or income, returns will not be required after such condition has been clearly established. Only one showing of this character is required, unless it appears later that the corporation has income within the meaning of the law.[42]

LIABILITY FOR TAX AFTER DISSOLUTION. Corporations in receipt of income during any part of the taxable year, but dissolved prior to the end of the year, are liable for the tax on such income.[43] Corporations which were dissolved in 1917, prior to the passage of the 1917 Law, were held subject to tax under the 1916 Law, as amended, and also under the 1917 Law.[44] The assets of a corporation are subject to

tax by dissolving before the time when it was required to make a return. (U. S. v. General Inspection & Loading Co., 192 Fed. 223.) When the same case came before the court for trial, it was held that notice addressed to the defendant at the place of its principal office at the time of its dissolution, presumptively received, was sufficient to warrant the collection of penalties (204 Fed. 657).

40 Revenue Act of 1918, § 250 (g).

41 See Chapter 35 on Assessment and Collection of the Tax.

42 T. D. 2137.

43 Reg. 45, Art. 621; U. S. v. General Inspection & Loading Co., 192 Fed. 223.

44 A corporation so situated was required to make a return covering the period in 1917 during which it was in business prior to its dissolution. If it should previously have made a return covering this period and paid any excess profits tax under the act of March 3, 1917, it credited the amount of such tax against any excess profits tax assessable against it under Title II of the act of October 3,

a lien for the payment of taxes, provided the corporation has not been dissolved, and all its assets distributed, prior to the time the list of assessments gets into the hands of the collector.

COLLECTION OF TAX FROM ASSETS. The Revised Statutes[45] as amended, provide generally with reference to internal revenue taxes that: "If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount shall be a lien in favor of the United States from the time when the assessment list was received by the collector, except when otherwise provided, until paid, with the interest, penalties and costs that may accrue in addition thereto, upon all property and rights belonging to such person." The Revenue Act of 1918 provides[46] that "all administrative, special or stamp provisions of law, including the law relating to the assessment of taxes so far as applicable, are hereby extended to and made a part of this Act." Under the 1916 Law it was the duty of the Commissioner of Internal Revenue to send to each collector a list of the companies liable for the tax in his district, showing the amounts for which they were liable, within such time that the collector might give the required notice of assessment on or before June first and upon such lists the collections were made. Under the provision of the Revised Statutes above quoted the lien was fixed upon the assets of the corporation when this list came into the collector's hands. Therefore, if the corporation had distributed all of its assets and become dissolved, in the manner provided by law, prior to that time there was nothing upon which the lien could attach, and consequently no lien existed to secure the payment of the tax which might be due from the corporation. The Revenue Act of 1918

1917. (Reg. 33 Rev., Art. 61.) This ruling was made on authority of Brady v. Anderson, 240 Fed. 665, writ of certiorari denied, 244 U. S. 654. See letter from Treasury Department dated November 17, 1917; I. T. S. 1918, ¶ 1085.

[45] R. S., § 3186.

[46] Revenue Act of 1918, § 1305.

changes the system of assessment and collection of the tax and the time when the lien attaches is uncertain. Although the statutes provide for a lien, this particular remedy for collecting the tax is not exclusive, and the Government may resort to the common law method of collecting the same.[47] The dissolution of a corporation does not extinguish its liabilities and through the courts of equity creditors may pursue its assets into the hands of any person who is not a *bona fide* purchaser. The sale of the entire capital stock of a corporation and the distribution of the proceeds of the sale among the stockholders will not defeat or impair the remedy of creditors, if any debts remain unpaid, as the creditors in that event may pursue the proceeds of the sale in the hands of the respective stockholders and compel each one to contribute *pro rata* toward the payment of the debts to the extent of the moneys received on the distribution.[48] This remedy is open to the Government in the same manner as it is to any other creditor for the collection of the tax,[49] but not for collection of the penalty for failure to file returns.[50]

Gross Income. Corporations are subject to tax on income received from all sources including gains, profits and income derived from trades, businesses, commerce or sales or dealings in property, whether real or personal growing out of ownership or use of or interest in such property, and from interest, rent, dividends, securities or the transaction of any business carried on for gain or profit, except income which is not to be included in gross income as provided in the Revenue Act of 1918. The items not to be included in gross income of a corporation are: (a) property

47 Dollar Savings Bank v. U. S., 19 Wall. 227.

48 Railroad Co. v. Howard, 7 Wall. 392.

49 28 Op. Atty. Gen. 241.

50 T. D. 1852. In the case of U. S. v. General Inspection and Loading Co., 192 Fed. 223, 204 Fed. 657, judgment was entered for tax, penalty for delay in the payment of the tax, and interest, under the 1909 Law, notwithstanding the fact that the corporation had been previously dissolved. But in this case the assets had not been distributed.

acquired by gift, bequest, devise or descent (but income from such property is taxable);[51] (b) interest upon (1) the obligations of a State, Territory, or any political subdivision thereof, the District of Columbia or any possession of the United States; (2) securities issued under the provisions of the Federal Farm Loan Act; (3) the obligations of the United States issued prior to September 1, 1917, and if issued after such date, if and to the extent the acts authorizing the issue thereof exempt the interest from taxation to the corporation both under the income and the profits taxes; (4) bonds issued by the War Finance Corporation, if and to the extent the acts authorizing the issue thereof exempt the interest from taxation to the corporation both under the income and the profits taxes;[52] and (c) income derived from the operation of a public utility to be acquired, constructed, operated or maintained by a corporation pursuant to a contract made with a State, Territory, or the District of Columbia, or any political subdivision of a State or Territory prior to September 8, 1916, in excess of the part thereof to which the corporation is entitled under such contract.[53] The gross income includes items subject to war-profits and excess-profits tax as well as

[51] Prior to the 1916 Law it was not clear that a corporation was exempt from tax on the value of property acquired by gift. Under the 1909 Law gifts to corporations were held to be taxable as income, although the law was silent. Under the 1913 Law it was held that the statutory exemption of gifts did not apply to corporations, since the 1913 Law provided for such exemption under a provision applicable to individuals only and made no mention of such exemption in the provisions applicable to corporations. The 1916 Law provided for the exemption of the value of gifts in a section applying with equal force to corporations and individuals. Compare Revenue Act of 1916, § 4 and Revenue Act of 1913, ¶ B.

[52] Although exempt bond interest is not included in gross income, it should be noted that every corporation owning any obligations, securities or bonds which are exempt must submit a statement showing the number and amount thereof and the interest received therefrom in such form and with such information as the Commissioner may require.

[53] Revenue Act of 1918, §§ 233 and 213.

income tax, but for the purpose of the latter these items are credited against the net income.[54] Where a corporation is engaged in carrying on more than one class of business, the gross income derived from the different classes is ascertained according to the rules applicable thereto and the gross income of all classes of business in which the corporation is engaged is taken to be the gross income of the corporation. Thus, the gross income of manufacturing companies consists of the total sales of manufactured goods during the year, increased or decreased by the gain or loss as shown by the inventories of finished and unfinished products, raw material, etc., at the beginning and end of the year; and mercantile companies proceed similarly in determining their gross income by inventory, adding in each case the income from all other sources.[55] The general provisions as to income applicable both to corporations and individuals are discussed in the succeeding chapters on income[56] and only the special provisions applicable to corporations are referred to in this chapter. All receipts by a corporation are not income, as is indicated in the following paragraphs and also in the chapters on income.

SALE OF CAPITAL STOCK. The amount received by a corporation in exchange for its capital stock is held to be capital of the corporation, whether or not the amount received is equal to or greater than the par value. Such transactions are purely capital transactions and the income is not increased by reason of the sale of the stock at a price greater than its par value.[57]

TREASURY STOCK. Treasury stock, whenever that term is used in connection with the accounts of the corporation or for income tax purposes, means stock which has been previously issued by the corporation and which has been re-possessed by it through purchase or otherwise and then

[54] Revenue Act of 1918, § 236.

[55] Reg. 33 Rev., Arts. 91 and 92. See also Reg. 33, Arts. 104 and 105.

[56] See Chapters 16 et seq.

[57] T. D. 2090; Reg. 45, Art. 542.

carried on its books as an asset. If such stock is resold at a price in excess of its cost upon repossession, such excess is income for the year in which resold. If, for the purpose of enabling a corporation to secure working capital, or for any other purpose, the stockholders donate or return to the corporation to be resold by it certain shares of stock of the company previously issued to them, the sale of such stock will be considered a capital transaction, and the proceeds of such sale will not constitute income to the corporation.[58]

CONTRIBUTION BY STOCKHOLDERS. Where a corporation requires additional funds for conducting its business and obtains such needed money through voluntary *pro rata* payments by its stockholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments in such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual stockholders, and will be treated as an addition to and as a part of the operating capital of the company. The cancellation by a stockholder of indebtedness owing from the corporation usually has the effect of increasing the capital and surplus of the corporation and not of producing income.[58a]

SALE OF CAPITAL ASSETS. Where property is acquired and later sold for a higher price, the gain on the sale is income. If, however, the property was acquired before March 1, 1913, only such portion of the gain as accrued subsequently to February 28, 1913, is taxable. Where, then, a corporation sells its capital assets in whole or in part, it shall include in its gross income for the year in which the sale was made the amount of the excess of the sales price over the fair market value of such assets as of March 1, 1913, if acquired prior to that date, or over their

58 Reg. 33 Rev., Arts. 98 and 99; Reg. 45, Art. 542.
58a Reg. 45, Art. 543.

cost if acquired subsequently to that date. In every case, however, in ascertaining the gain, the cost of the assets, or the fair market value as of March 1, 1913, of the assets acquired prior thereto, should first be reduced by the amount of any charges for depreciation, depletion and other losses which have been or should have been made. If the purchaser takes over all the assets and assumes the liabilities, the amount so assumed is part of the purchase price. If the sale is made for stock of another corporation the rules relating to income from exchange of property will apply.[58b]

INTEREST UPON LIBERTY BONDS. Income of a corporation as such is taxable to the corporation and not to the stockholders. The corporation, and not the stockholders, is regarded as the owner of Liberty Bonds held by the corporation and is entitled to exemption on account of such ownership. Thus, when bonds of the Fourth Liberty Loan are subscribed for by the corporation, it, and not the stockholders, is the original subscriber and is entitled to the collateral exemption of interest on bonds of previous issues on account of such original subscription.[59]

Deductions in Computing Net Income. The statute specifies particularly the deductions which may be made from gross income in computing net income subject to tax. These deductions are discussed generally in the several chapters relating respectively thereto. In this chapter reference is made only to those provisions having special application to corporations.

Ordinary and Necessary Expenses. A corporation is allowed to deduct all the ordinary and necessary expenses paid or incurred [60] during the taxable year in carrying on any trade or business, including a reasonable allowance for

[58b] Reg. 45, Art. 544. See Chapter 20.

[59] T. D. 2742. See Chapter 16 on Income—In General.

[60] The terms "paid or incurred" or "paid or accrued" are construed according to the method of accounting upon which net income is computed under § 212 of the Revenue Act of 1918. (Revenue Act of 1918, § 200.)

salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which is has no equity.[61] It will be noted that the expenses permitted by this provision of law are only the ordinary and necessary expenses. Extraordinary expenses are not deductible under this head and if by law may or may not be permitted in computing net income, although they may be deductions recognized in accounting practice as a proper charge against the income for the year.

ORGANIZATION EXPENSES. Organization expenses of corporations such as attorneys' and accountants' fees together with fees paid to the state authorities prior to or coincident with the securing of a charter and the incorporation of a company constitute a capital investment, such assets being offset by the asset value of the corporate franchise, an intangible asset of a somewhat permanent character and in many instances of substantial value. It has been held that such expenses incident to and connected with the incorporation and organization of the company are not ordinary and necessary expenses, which are the only "expenses" authorized by the law to be deducted.[62]

EXPENSES INCURRED IN SALE OF CAPITAL STOCK. Any and all expenses incidental to or connected with the selling of the capital stock (common or preferred) of a corporation for the purpose of raising capital to be invested by it in property or employed in the business for which the corporation is organized are not a necessary and ordinary expense, and such expense is not an allowable deduction from gross income, for the reason that it is incurred in a capital transaction; that is, the raising of capital to be invested or

61 Revenue Act of 1918, § 234 (a) 1.

62 T. D. 2490. This ruling is not in accordance with accounting practice, which recognizes the propriety of charging off organization expenses against income over a period of four or five years, and the rule may be changed under the present law. See § 232 of the law.

employed in the business. Such expense, like the discount at which the shares of stock may be sold, has the effect only of reducing the available capital of the corporation and cannot be used to reduce the income from operations; that is to say, any expense incident to the bringing of capital into the company, whether it be a new or a going concern, cannot be recouped out of or charged against the operating income. It is a capital loss or expense properly chargeable against the proceeds of the sale of the stock and reduces the capital rather than the earnings of the company.[63]

PAYMENTS IN LIEU OF RENT. This item includes all royalties or other charges, including any interest payment which the corporation is required to make for the right to use and possess property in which it has no control, interest or equity.

Interest. With one exception the limitations[64] contained in the 1916 Law upon the deduction of interest by corporations are not imposed by the Revenue Act of 1918 and, corporations, like individuals, may now deduct all interest paid within the taxable year on their indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is wholly exempt from taxation for income tax purposes as income to the corporation.[65]

Taxes. Corporations, like individuals, may deduct taxes paid or accrued,[66] within the taxable year imposed (a) by the authority of the United States except income, war profits and excess-profits taxes, (b) by the authority of any possessions of the United States except income, war profits and excess-profits taxes, (c) by the authority of any State or Territory, or any county, school district, municipality, or other taxing subdivision of any State or Terri-

63 Reg. 33 Rev., Art. 145.

64 See Note No. 167 at the end of this chapter for statement of the rules relating to deduction of interest under the 1916 Law.

65 Revenue Act of 1918, § 234 (a) 2.

66 See note 60.

tory, or (d) by the authority of any foreign country except income, war profits and excess-profits taxes.[67] The same rules apply to deduction of taxes by corporations and individuals and are discussed elsewhere.[68]

INTEREST ON TAX-FREE BONDS. Where a corporation has issued bonds or other indebtedness with a guarantee that the interest thereon shall be paid without deduction for any tax which the corporation may be called upon to pay or withhold under the laws of the United States or of any State or jurisdiction, no deduction for the payment of the income tax or any other tax paid pursuant to the contract or provision contained in such bonds is permitted to the corporation under the heading of taxes (or the heading of interest).[69]

Losses. Corporations are permitted to deduct all losses sustained during the taxable year and not compensated for by insurance or otherwise.[70] One ruling on losses, having application only to corporations, is given below.

REDEMPTION OF PREFERRED STOCK. Where a corporation issued preferred stock at par, redeemable at 110, the difference appearing on the books of the corporation as a reduction of undivided profits, the transaction has been held to be a capital transaction in which there could be no gain or loss to the corporation, and, therefore, the difference be-

67 Corporations are entitled to a credit against their tax for income, war-profits and excess-profits taxes imposed by authority of any foreign country or any possession of the United States. (Revenue Act of 1918, § 238.)

68 See Chapter 29 on Deduction of Taxes.

69 Revenue Act of 1918, § 234 (a) 3; Reg. 45, Art. 564.

70 "A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade," a reasonable allowance for actual reduction in flow and production, in the case of oil and gas wells, and depletion of mining deposits, were included in the section allowing the deduction of losses under the 1916 Law (Revenue Act of 1916, § 12 (a)). The corresponding deductions under the present law are provided for separately and are discussed in paragraphs below.

tween the selling price of the stock and the price which it was redeemed could not be deducted as a loss.[71]

Losses of Taxable Year 1918. The Revenue Act of 1918 contains a new provision permitting the deduction by individuals and corporations of (a) substantial losses (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for the taxable year 1918 and (b) substantial losses arising from the actual payment after the close of the taxable year 1918 of rebates in pursuance of contracts entered into during such year upon sales made during such year.[72] This subject is more fully discussed elsewhere.[73]

Net Losses. If for any taxable year beginning after October 1, 1918, and ending prior to January 1, 1919, any corporation has sustained a net loss,[74] the same is allowed as a deduction in computing its net income for the *preceding* taxable year, and the income and war-excess profits taxes imposed by the Revenue Act of 1918 for such preceding taxable year may be redetermined accordingly. Any amount found to be due to the corporation upon the basis of such redetermination is credited or refunded to the corporation, and if such net loss for the preceding taxable year is in excess of the net income for the same year, the amount of such excess may be allowed as a deduction in computing the net income for the succeeding taxable year.[75] Such net loss must be proved by evidence satisfactory to the Commissioner of Internal Revenue and the deduction thereof is subject to regulations to be prescribed by him with the approval of the Secretary of the Treasury. This subject is more fully discussed in another chapter.[76]

71 Letter from Treasury Department dated April 11, 1917; I. T. S. 1918, ¶ 1448. The ruling is different as to the redemption of bonds sold at a discount. See Chapter 30 on Deduction of Losses.

72 Revenue Act of 1918, § 234 (a) 12.

73 See Chapter 30 on Deduction of Losses.

74 Id.

75 Revenue Act of 1918, § 204 (b).

76 See Chapter 30 on Deduction of Losses.

Worthless Debts. Corporations may deduct all debts ascertained to be worthless and charged off within the taxable year.[77] This deduction is allowed to both individuals and corporations and is more fully discussed in another chapter.[78]

Dividends on Stock of Other Corporations. Corporations may now deduct all amounts received as dividends from a corporation taxable upon its net income and amounts received as dividends from a personal-service corporation out of earnings or profits upon which income tax has been imposed.[79] Dividends received from foreign corporations paying no income tax to this government may not be deducted, but if the foreign corporation pays a tax on income from this country the dividends are partially exempt.[80]

Depreciation. Corporations are permitted a reasonable allowance for the exhaustion, wear and tear of property used in their trade or business including a reasonable allowance for obsolescence.[81] This subject is fully discussed elsewhere in this book.[82]

Amortization. In the case of buildings, machinery, equipment, or other facilities constructed, erected, installed or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the war with Germany, and in the case of vessels constructed or acquired

77 Revenue Act of 1918, § 234 (a) 5.

78 See Chapter 30 on Deduction of Losses.

79 Revenue Act of 1918, § 234 (a) 6. Under the 1913 Law corporations were not permitted to deduct the amount received as dividends from other corporations subject to the income tax. This was likewise true under the 1916 Law. For the purpose of the 1917 Law, dividends on the stock of such other corporations as were taxable thereunder on their net income might be deducted. Thus, in 1917 a corporation might not deduct dividends in computing the 2% tax imposed by the 1916 Law, but might do so in computing the 4% tax imposed by the 1917 Law.

80 See Chapter 23 on Dividends.

81 Revenue Act of 1918, § 234 (a) 7. The corresponding deduction under the 1916 Law was included in the provision in respect to losses (Revenue Act of 1916, § 12).

82 See Chapter 31 on Depreciation.

on or after such date for the transportation of articles or men contributing to the prosecution of the war with Germany, a reasonable deduction is allowed to corporations for the amortization of such part of the cost of such facilities or vessels as has been borne by the corporation, but not again including any amount otherwise allowed under the Revenue Act of 1918 or previous income tax laws as a reduction in computing net income. At any time within three years after the termination of the war with Germany on the date fixed by proclamation of the President, the Commissioner of Internal Revenue may, and at the request of the corporation must, re-examine the return and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income and war profits and excess-profits taxes for the year or years affected must be re-determined and the amount of the tax due upon such re-determination, must be paid by the corporation upon notice and demand by the collector. The amount of tax overpaid, if any, must be credited or refunded to the corporation. This deduction is allowed also to individuals and is discussed more fully in a subsequent chapter.[83]

Depletion. Corporations are permitted the same allowance in the case of the depletion of mines, oil and gas wells, other natural deposits, and timber, and for depreciation of improvements as is allowed to individuals.[84] This subject is discussed elsewhere in this book.[85]

Items Not Deductible. Certain items are expressly declared by the Revenue Act of 1918 not to be deductible in the case of corporations as well as individuals.

[83] Revenue Act of 1918, §§ 1, 234 (a) 8. See Chapter 31 on Depreciation.

[84] Revenue Act of 1918, § 234 (a) 9. A deduction was included under losses in the 1916 Law "in the case of oil and gas wells" consisting of "a reasonable allowance for actual reduction in flow and production," and "in the case of mines, a reasonable allowance for depletion thereof." (Revenue Act of 1916, § 12.)

[85] See Chapter 32 on Depletion.

IMPROVEMENTS AND BETTERMENTS. In computing net income no deduction is allowed to corporations for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.[86] This is a reasonable limitation since amounts of capital invested in permanent improvements or betterments add to the value of the property. The subjects of this paragraph and the following paragraph are discussed more fully elsewhere in this book.[87]

RESTORATION OF PROPERTY. No deduction is allowed to corporations for any amount expended in restoring property or making good the exhaustion thereof, for which an allowance is or has been made.[88] This is also a reasonable limitation since if such property is subject to wear and tear or depletion, the additional amount so invested in the property may be taken into consideration in computing the allowance for depreciation or depletion.

INSURANCE ON OFFICERS AND EMPLOYEES. Corporations are not permitted to deduct any amount paid in premiums on any life insurance policy covering the life of any officer or employee, or of any person financially interested in the trade or business carried on by the corporation, when it is directly or indirectly a beneficiary under such policy. This subject is more generally discussed elsewhere in this book.[89]

Credits Against Net Income. In addition to the above mentioned deductions, corporations are allowed certain credits against net income. Credits differ from deductions in the case of corporations in that deductions reduce the net income for the purpose of all taxes, while credits reduce the net income for the purpose of the income tax and not for the purpose of the war-profits and excess-profits taxes. The credits are as follows:

86 Revenue Act of 1918, §§ 235 and 215 (b).

87 See Chapter 26.

88 Revenue Act of 1918, §§ 235 and 215 (c).

89 Revenue Act of 1918, §§ 235 and 215 (d). The 1916 Law contained a similar provision. (Revenue Act of 1916, § 32.) See page 435.

INTEREST UPON OBLIGATIONS OF THE UNITED STATES. Corporations are allowed to deduct for purpose of income tax any amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation which is included in gross income.[90]

The amount of interest received upon obligations of the United States issued prior to September 1, 1917, is exempt from all taxation, and is excluded from the gross income of a corporation. The amount of interest upon obligations of the United States issued after September 1, 1917, and upon bonds issued by the War Finance Corporation is exempt from taxation only if and to the extent provided in the respective acts authorizing the issue thereof, as amended and supplemented and is excluded from gross income only if and to the extent it is wholly exempt from both income and war-profits and excess-profits taxation. Interest upon such obligations and bonds which must be included in gross income, is, however, credited for the purpose of the income tax. The interest upon obligations of the United States issued after September 1, 1917, and upon bonds of the War Finance Corporation is exempt from all taxation to a certain extent and to the extent that it is thus free from all taxation is omitted from gross income.

AMOUNT OF WAR-PROFITS AND EXCESS-PROFITS TAX. Corporations are also allowed to deduct for purposes of income tax, the amount of the war-profits and excess-profits tax imposed for the same taxable year.[91] In the case of a corporation making return for a fiscal year beginning in 1917 and ending in 1918, or beginning in 1918 and ending in 1919, certain special rules apply, which are set forth elsewhere in this book.[92]

SPECIFIC EXEMPTION. Domestic corporations are permitted to deduct for purpose of income tax the sum of

[90] Revenue Act of 1918, § 236 (a).
[91] Revenue Act of 1918, § 236 (b).
[92] See Page 215.

$2,000 as a specific exemption.[93] The 1916 Law and the 1913 Law contained no similar provision.

Credits Against Tax. Domestic corporations may credit against the amount of tax which would be due on income derived from all sources the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country upon income derived from sources therein or to any possession of the United States.[94]

Holding and Subsidiary Corporations. Except as indicated in the following paragraphs, the fact that one corporation held the entire capital stock of another and that the two were component parts of one business unit or system did not, under the 1916 Law, destroy the separate entities of the two corporations. As a general rule corporations as such were subject to the tax, not the business organizations of which the corporations might be a part. Every corporation was considered to be a distinct entity regardless of its relation to any other corporation.[95] Where a parent corporation owned all or practically all of the stock of subsidiary companies, each was required to make a true and correct return accounting in detail for their separate gross incomes and deductions, and each was generally required to pay the tax on the net earnings shown by such return. The parent company was not permitted to report the gross income of all the subsidiaries and deduct therefrom the gross expenses.[96] The net earnings of the subsidiary companies turned over to the parent company were to be treated as dividends, notwithstanding the earnings out of which the dividends were paid were also subject to tax, as against the subsidiary companies.[97] In

[93] Revenue Act of 1918, § 236 (c).

[94] Revenue Act of 1918, § 238. See Chapter 33.

[95] The Revenue Act of 1918 contains a new provision providing for filing of consolidated income tax returns and to the extent indicated in the later paragraphs of this chapter the rules stated in the text above have been modified.

[96] T. D. 2137; T. D. 2090.

[97] Revenue Act of 1918, § 234 (a) 6.

a case under the 1909 Law it was held that although the affairs of the holding and operating company were closely connected and they had officers in common, the distinct corporate existence of each should not be ignored and the holding company should not be treated as being engaged in the business of the operating company.[98]

INACTIVE SUBSIDIARIES. It was held in an early ruling that the fact that a corporation has a number of subsidiaries only for the purpose of protecting trade brands, trade marks and trade names was immaterial; that the liability to make sepaarte returns attached to each subsidiary company by reason of the fact that it was a separate and distinct entity. If such subsidiary had no net income or earnings and no expense of operations, and if the earnings accrued direct to the parent company, which also paid direct the operating expenses of the subsidiaries, those facts should be set out in the return of the subsidiary, but they did not operate to release the subsidiary from liability to make a return.[99]

SUBSIDIARIES OPERATED AS INTEGRAL PARTS. If subsidiary corporations existed in name only, or were mere agents or integral parts of the parent corporation and as such, transacted no business and had no income of and for their own account, and incurred no expenses, all business being transacted, all income being received and all expenses being paid directly by the parent company, no separate accounts being kept by or for such subsidiaries, it was considered that such subsidiary concerns had no taxable income. In such csaes, however, such subsidiary corporations were required to make returns and indorse thereon a statement to the effect that the corporation making the return was a subsidiary or integral part of the parent company (naming it) and that, for its own account, it had no income from any source whatever, that it made no disbursements, and that all the business done in its name was done for the account of and was the business of the parent corpora-

[98] U. S. v. Nipissing Mines Co., 206 Fed. 431, 234 U. S. 765.
[99] T. D. 2161.

tion, and would be accounted for in the return of such parent corporation. This ruling was not intended to cover those subsidiary corporations which actually transacted business in their own names, received income for their own account, which incurred and paid expenses incident to the production of such income, which kept separate books of account, and which, as separate entities, exercised all the powers and functions authorized by their charters. Corporations of this character were required to pay the income tax on the net income received by them from all sources, regardless of the fact that such net income was paid or turned over to a parent or holding company, by whom it was also returned for the purpose of the tax.[100]

LEGAL TITLE TO EARNINGS OF SUBSIDIARIES. Where a subsidiary company kept no bank account, but its earnings were deposited in the bank account of the parent company which advanced the necessary funds whenever needed by the subsidiary for any operating expenses, or for additions or betterments, it was held that dividends, received by the controlling company and declared and paid during the first six months of 1914 out of surplus of the subsidiary company accumulated prior to January 1, 1913, and on such date consisting principally of a debit on the books of the subsidiary company, kept in accordance with the lease under which the controlling company operated the subsidiary company, were not taxable as income received in 1914 by the controlling company. It was also held that the time of the declaration or payment of the dividends was immaterial; that the declaration and payment thereof was a paper transaction to bring the books into accord with the acknowledged rights of the controlling company; that such dividends bore the appearance of accruing and in form only accrued to the controlling company after January 1, 1913; that, prior to such date, while the two companies were separate legal entities, yet in fact and for all practical purposes they were merged

100 Reg. 33 Rev., Art. 208.

and identical, the subsidiary company being but a part of the controlling company, acting merely as its agent and subject in all things to its direction and control, the funds in question being in the actual possession and control of the holding company as well before as after the declaration.[101] The doctrine of this case has since been somewhat extended. Where a holding company, owning all the stock in several subsidiary companies except the qualifying shares held by directors which holding company and subsidiary companies constituted and were related as parts of a single enterprise of buying, transporting, refining and selling oil and which subsidiary companies had retained their earnings although making some loans *inter sese* and had invested in properties all their funds which were not actually required to carry on the business so that the debtor companies had no money to pay their debts, decided in January, 1913, to take over the previously accumulated earnings and surplus of such subsidiaries and actually did so in 1913 by votes of the subsidiaries, the court disregarded the forms gone through and the distinct corporate entities, and considered only the result which was that the holding company became the holder of the debts previously due from one subsidiary to another, was no richer than before, but its property, formerly represented only by stock in the subsidiaries, was thereafter represented by stock in *and debts due from* such subsidiaries. The changes having been effected by entries on the respective companies' books, the transaction was held to be a bookkeeping transaction and not a declaration and payment of dividends in the ordinary course by the subsidiaries. Although the holding company *did not itself do the business of the subsidiaries and have possession of their property*, the court nevertheless followed the principle of the case last discussed.[102]

101 Southern Pacific Co. v. Lowe 247 U. S. 330. This case turned upon its very peculiar facts and is explained in Peabody v. Eisner, 247 U. S. 347.

102 Gulf Oil Corporation v. Lewellyn, 248 U. S. 71.

TAXABILITY OF HOLDING COMPANIES ON BOOKKEEPING CREDITS. The Treasury Department held under former laws that in a case wherein a holding company actually takes up each month on its books its proportionate share of the earnings of the underlying companies, such holding company will be required to include in its gross income the amounts thus taken up regardless of the fact that the same may not have been actually paid to it in cash. The fact that the underlying companies credit to the holding company the amount of the earnings to which it is entitled on the basis of the stock it holds, together with the fact that the holding company takes up on its books the amount thus credited, renders it incumbent upon the holding company to return these amounts as income, regardless of the fact that the underlying companies needed the earnings and actually used them in making extensions and improvements and in furtherance of their business.[103] Since dividends are not taxable under the present law, this ruling has no application except as to past years.

GIFTS TO SUBSIDIARIES. In cases where holding companies have made "gifts" to their subsidiaries to make up a deficit at the end of the accounting period of the subsidiary it has been held by the Treasury Department that such "gifts" were not a proper deduction from the net income of the holding company and were not exempt when received by the subsidiary. This ruling has no application under the Revenue Act of 1918, so far as the receipt of the gift is concerned, since gifts are not included in the gross income of corporations or of individuals.[104]

Lessor and Lessee Corporations. When a corporation leases its property in consideration that the lessee pay in lieu of rental an amount equivalent to a certain rate of dividend on its capital stock or the interest on its out-

103 T. D. 2137.

104 Revenue Act of 1918, §§ 233 and 213. The ruling cited in the text was supported by the provision of the 1913 Law relating to the exemption of gifts, but would seem to have had no authority in the 1916 Law. See note 51.

standing indebtedness, together with taxes, insurance, or other fixed charges, such payments are considered rental payments and should be returned by the lessor corporation as income, notwithstanding the fact that the dividends and interest are paid direct to the stockholders and bondholders of the lessor. The lessee, in making these payments direct to the bondholders and the stockholders, does so as the agent of the lessor, and the latter is none the less liable to return the amounts thus paid as income and to pay any tax that may be due thereon.[105] Where under the terms of a lease a lessee agreed to pay the interest upon and discharge the bonds issued by the lessor, to maintain the right of way and buildings, and to pay direct to each stockholder of the lessor dividends at the rate of eight per cent. per annum, it was held that the amounts paid to the creditors and stockholders of the lessor were rents or compensation to the lessor for the use and occupation of its property and consituted net income to it. It was held to be immaterial that the lessor was not possessed of money or other cash revenues with which to pay the tax. The lessor could not exonerate itself from liability for the tax subsequently imposed under a law thereafter enacted by making a lease of its property which provided for the payment of all its surplus revenues direct to its stockholders.[106] The notion that a corporation is an artificial entity distinct from the members who compose it is a fiction of the law which the courts recognize for some purposes and disregard for others. Thus, the fact that a lessee corporation pays the rent not to the lessor corporation but to its stockholders and bondholders, cannot prevent the lessor corporation from being taxable.[107]

LESSEE CORPORATIONS. A railroad company operating leased or purchased lines as an integral part of its line or system, and keeping no separate books of account as to

105 Reg. 33 Rev., Arts. 102 and 125.

106 Rensselaer & Saratoga Railroad Co. v. Irwin, 249 Fed. 726, writ of certiorari denied, 246 U. S. 671.

107 Anderson v. Morris & Essex Railroad Co., 216 Fed. 83.

such leased or purchased line, and the income from the operating of which cannot be segregated, is required to include in its income all receipts derived therefrom, and if bonded or other indebtedness of the leased or purchased line has been assumed by the operating company, it may deduct from its gross income the interest paid on such indebtedness. In this event the leased or purchased line, so long as it has a corporate existence, will make return of income setting out that on its own account it has neither income nor expenses, and that both are taken up in the return of the operating company, naming it.[108] The indebtedness of the lessor corporation should not be included in the statement of the indebtedness of the lessee, unless the lessee has assumed the same.[109]

LESSOR CORPORATIONS. If the leased or purchased line keeps separate books of account, or the income from its operations is, or can be, segregated, or if the lessee or operating company pays it a certain rental, or in lieu of rental pays as a rental equivalent a certain percentage of dividends on its outstanding capital stock, interest on its bonds, taxes, etc. (even though such rental equivalent be paid by the lessee directly to the stockholders and bondholders of the lessor) the lessor should nevertheless return the rental so paid as its income and will be subject to tax accordingly, and the lessee or operating company should make its return as though it were in no way related to the line.[110] If the lessor and lessee are affiliated the income of both would be included in a consolidated return.

STOCK TRUST CERTIFICATES. Stock trust certificates or leased line certificates, as the case may be, issued by the lessee for the purpose of securing or holding control of the stock of the lessor are held to be issued in lieu of the certificates of capital stock, and for the purpose of the income tax will be treated as capital stock; the amounts received by the holders of these certificates are dividends

108 Reg. 33 Rev., Art. 125; see Reg. 33 Rev., Art. 208.
109 Reg. 33, Art. 82.
110 Reg. 33 Rev., Art. 125.

to the holders, to be treated as rentals by both lessee and lessor and constitute an allowable deduction in the one case and an item of income in the other, accordingly as they are paid and received.[111]

TREATMENT OF INCOME BY STOCKHOLDERS AND BONDHOLDERS OF LESSOR. Where the lessor corporation is required to report as its own income the amount paid to its stockholders and bondholders by the lessee, the stockholders should treat the amounts received from the lessee as dividends on the stock which they hold in the lessor company. In paying direct to the stockholders the lessee is held to be acting as the agent of the lessor and the amounts received by the stockholders are in effect and in fact dividends received out of the earnings of the lessor and consequently not subject to the normal tax.[112] Similarly bondholders of the lessor company should treat the amounts received from the lessee as interest upon the indebtedness of the lessor.

Receivers for Corporations. The Revenue Act of 1918 provides that in cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees or assignees is collected in the same manner as if collected from the corporations of whose business or property they have custody or control.[113] Receivers of corporations are not fiduciaries within the meaning of the law and are not governed by the same rules as are made applicable to receivers for individuals.[114] The receiver of

111 Reg. 33 Rev., Art 104; Reg. 45, Art. 545.

112 T. D. 2090; Reg. 45, Art. 545.

113 Revenue Act of 1918, § 239.

114 Reg. 45, Art. 424. This is true in view of the express provision of § 239 of the Revenue Act of 1918, notwithstanding the definition of "person" and "fiduciary" contained in § 200. See Chapter 8 on Fiduciaries.

a corporation stands in the same position as the officers of a solvent corporation and upon him devolve all the duties of such officers as to the making of returns and payment of tax. The fact that the business and property of the corporation are temporarily in the hands of a receiver does not alter the fact that the corporation is none the less the beneficiary of the income arising and accruing. If there is net income in excess of credits, it is taxable, and the custodian of such income is liable for the tax assessable thereon.[115] A receiver in charge of only part of the property of a corporation, however, as a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make a return of income.[115a]

Fiscal Year. A corporation is required to make returns and pay the tax on the basis of its annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping its books, unless (a) no such method of accounting has been employed, or (b) the method employed does not clearly reflect income. In case of (a) and (b) the computation of net income is made on such basis and

115 Under the 1913 Law, as well as under the 1909 Law, there was no express provision in the statute taxing corporations in the hands of receivers. Several cases under the 1909 Law held that that act did not impose a tax on such corporations or any duties on the receivers thereof. (See Pennsylvania Steel Co. v. New York City Railways Co., 198 Fed. 774.) The 1909 Law was a tax on corporations doing business and it was held in several cases that a corporation in the hands of receivers was not one doing business within the meaning of those words as used in that act. Only one decision seems to have been rendered under the 1913 Law and in that case it was held that receivers were not subject to the income tax where the court took possession of the property of an insolvent railroad company and operated the railroad. The funds in the hands of the receivers, represented by the net proceeds in conducting the operation of the road, over and above the authorized expenditures paid out by them, were held not to be subject to the tax as "net earnings." (Equitable Trust Co. v. Western Pac. Ry. Co., 236 Fed. 813.) The question was no longer left open under the express provisions of the 1916 Law.

115a Reg. 45, Art. 622.

in such manner as in the opinion of the Commissioner does clearly reflect income. If the corporation's annual accounting period is other than a fiscal year as defined in the next paragraph, or if the corporation has no annual accounting period, or does not keep books, its net income is computed on the basis of the calendar year. In the event of any change of accounting period from fiscal year to calendar year, or vice versa, or from one fiscal year to another, net income is computed on the basis of such new accounting period, subject to the rules outlined in a later paragraph.[116] Reporting upon the basis of a fiscal year was formerly a privilege accorded to corporations only. It is now a requirement if the annual accounting period of the corporation is a fiscal year. This subject is more fully treated in another chapter.[117]

REQUIREMENTS AS TO FISCAL YEAR. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December.[118] No return received for a period ending on any date other than the last day of some month will be accepted, unless it is a "final return" and made to the day the corporation ceased business.[119]

HOW DESIGNATED. In the case of a corporation reporting on the basis of the calendar year as its fiscal year, no notice or formality was required under the 1916 Law, which gave the privilege of reporting on the basis of a fiscal year different from the calendar year to corporations; but where the fiscal year constituting such basis did not coincide with the calendar year, notice of the adoption of a fiscal year was required to be filed with the local collector. Under the 1916 Law, the fiscal year might be designated by giving notice of the day chosen as the closing of the fiscal year to the collector of the district in which the corporation filed its return, at any time not less than thirty

116 Revenue Act of 1918, §§ 212 and 232; Reg. 45, Art. 25.
117 See Chapter 34 on Returns.
118 Revenue Act of 1918, § 200.
119 Mimeograph letter to Collectors, No. 1148.

days prior to the date on which its return would have been filed, if made upon the basis of the calendar year.[120] Under the requirements of the Revenue Act of 1918 no fiscal year will be recognized unless before its close it was definitely established as an accounting period and the books of the corporation kept in accordance therewith, unless, with the approval of the Commissioner, it has changed the basis of computing its net income.[120a]

CHANGING THE ACCOUNTING PERIOD. If a corporation, with the approval of the Commissioner of Internal Revenue, changes its basis of computing net income from a fiscal year to the calendar year, it makes a separate return covering the period between the close of the last fiscal year for which it made return, and the following December 31. If it changes such basis from the calendar year to a fiscal year, it makes a separate return for the period between the close of the last calendar year for which it made return, and the date designated as the close of the fiscal year. If it changes such basis from one fiscal year to another fiscal year, it makes a separate return for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year. In all three of these instances of separate return, net income is computed on the basis of the period for which the separate return is made, and the tax is paid at the rate for the calendar year in which the period is included.[121] If a corporation changes its accounting period, it shall, as soon as possible, give written notice to the collector for transmission to the Commissioner of such change and its reasons therefor. The Commissioner will not approve a change of the basis of computing net income unless such notice is given (a) at least 30 days before the due date of the taxpayer's return on the basis of its existing taxable year and (b) at least 30 days before the due date of its return on the basis of the proposed taxable year. If the change in the

120 Reg. 33 Rev., Art. 203; T. D. 2090; T. D. 2152; T. D. 2137.
120a Reg. 45, Art. 25.
121 Revenue Act of 1918, § 226.

basis of computing the net income of the taxpayer is approved by the Commissioner, the corporation shall thereafter make its return upon the basis of the new accounting period.[121a]

RATES OF TAX IN CASE OF FISCAL YEAR ENDING IN 1918 OR 1919. The method provided for computing the tax for a fiscal year beginning in 1917 and ending in 1918 is as follows: (a) The tax attributable to the calendar year 1917 is found by computing the income of the taxpayer and the tax thereon in accordance with Title I of the Revenue Act of 1916 as amended and Title I of the Revenue Act of 1917 as if the fiscal year was the calendar year 1917, and determining the proportion of such tax which the proportion of the fiscal year falling within the calendar year 1917 is of the full fiscal year; (b) the tax attributable to the calendar year 1918 is found by computing the income of the taxpayer and the tax thereon in accordance with the present statute as if the fiscal year was the calendar year 1918, and determining the proportion of such tax which the portion of such fiscal year falling within the calendar year is of the full fiscal year; and (c) the tax for the fiscal year is found by adding the tax attributable to the calendar year 1917 and the tax attributable to the calendar year 1918. If a corporation made its return for the taxable year 1917 on the calendar year basis and for the taxable year 1918 on a fiscal year basis, the tax attributable to the calendar year 1918 computed as above shall be the tax of the corporation for the portion of such fiscal year falling within the calendar year 1918. A personal-service corporation is not required to pay the tax attributable to the calendar year 1918, since for that year it is treated substantially like a partnership for the purposes of taxation. The method provided for computing the tax for a fiscal year beginning in 1918 and ending in 1919 is as follows: (a) the tax attributable to the calendar year 1918 is found by computing

121a Reg. 45, Art. 26.

the income of the taxpayer and the tax thereon in accordance with the statute as if the fiscal year were the calendar year 1918, and determining the proportion of such tax which the portion of such fiscal year falling within the calendar year is of the full fiscal year; (b) the tax attributable to the calendar year 1919 is found by computing the income of the taxpayer and the tax thereon in accordance with the statute as if the fiscal year were the calendar year 1919, and determining the proportion of such tax which the portion of such year falling within the calendar year is of the full fiscal year; and (c) the tax for the fiscal year is found by adding the tax attributable to the calendar year 1918 and the tax attributable to the calendar year 1919.[122]

CREDIT OF WAR-PROFITS AND EXCESS-PROFITS TAXES. In computing the tax as indicated in the preceding paragraph in the case of a corporation making a return for a fiscal year beginning in 1917 and ending in 1918, the 1917 war excess-profits taxes computed for the entire period will be credited against the net income computed for the entire period under the Revenue Act of 1916, as amended, and under the Revenue Act of 1917. The war-profits and excess-profits taxes computed for the entire period under the Revenue Act of 1918 at the rates prescribed for the calendar year 1918 will be credited against the net income computed for the entire period under the Revenue Act of 1918.[123] Thus, in the case of such a corporation six months of whose fiscal year fell within the calendar year 1917 and the remaining six months of whose fiscal year fell within the calendar year 1918, the income tax will be (a) one-half of a tax for the entire period computed under the Revenue Act of 1916, as amended, and the Revenue Act of 1917, plus (b) one-half of a tax for the entire period computed under the Revenue Act of 1918 at the rates for the calendar year 1918. In computing the income tax of

[122] Revenue Act of 1918, § 205; Reg. 45, Arts. 1622, 1625.
[123] Revenue Act of 1918, §§ 236, 205.

such a corporation the net income for the entire period under the Revenue Act of 1916, as amended, and the Revenue Act of 1917, will be credited with the war excess-profits tax for the corresponding period before the entire tax (one-half of which is later to be taken) is computed, and likewise the net income computed for the entire period under the Revenue Act of 1918 will be credited with the amount of war-profits and excess-profits taxes paid for the corresponding period before the entire tax (one-half of which is later to be taken) is computed.

CREDIT FOR TAXES. In the case of a corporation making return for a fiscal year beginning in 1917 and ending in 1918 only that proportion of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country upon income derived from sources therein or to any possession of the United States will be allowed which the part of such period within the calendar year 1918 bears to the entire period.[124]

NEW CORPORATIONS. The Revenue Act of 1918 provides that "if a taxpayer making his first return for income tax keeps his accounts on the basis of a fiscal year he shall make a separate return for the period between the beginning of the calendar year in which such fiscal year ends and the end of such fiscal year."[125] This section is made applicable by reference to corporations, and would necessarily apply only to new corporations. This provision is vague but probably means that if a corporation organized in September, 1918, opens its accounts on the basis of a fiscal year ending November 30, it should file its first return for the period from its date of organization to November 30, 1918. But if it is organized in September and opens its accounts on the basis of a fiscal year ending June 30, there seems to be no reason why its first return should not be for the period beginning with its date of organization and ending June 30 in the following year.

124 Revenue Act of 1918, § 238 (b).
125 Revenue Act of 1918, §§ 226 and 232; Reg. 45, Art. 25.

Returns. The duty to make a return depends upon corporate existence and not upon the receipt of income. Every corporation not specifically enumerated as exempt is required to make a return whether or not it has any income liable to tax. Copies of the prescribed return forms will be furnished corporations by collectors. Failure on the part of any corporation liable to tax to receive a prescribed blank form will not, however, excuse it from making the return. Corporations not supplied with the proper forms should make application therefor to the collector in ample time to have their returns prepared, verified and filed with the collector on or before the last due date. Each corporation should carefully prepare its return so as fully and clearly to set forth the data therein called for. Imperfect or incorrect returns will not be accepted as meeting the requirements of the statute. In lack of a prescribed form a statement made by a corporation disclosing its gross income and the deductions therefrom may be accepted as a tentative return, and if filed within the prescribed time a return so made will relieve the corporation from liability to penalties, provided that without unnecessary delay such a tentative return is replaced by a return made on the proper form, or extension of time is obtained.[196]

WHEN FILED. Returns of income must be made on or before the fifteenth day of the third month following the close of the fiscal or calendar year for which the return is required to be made. A corporation going into liquidation during any taxable year may upon the completion of such liquidation prepare a return covering its income for the fractional part of the year during which it was

[196] Reg. 45, Arts. 621 and 626; Reg. 33 Rev., Art. 203; Reg. 33, Art. 80. Under the 1909 Law it was held that corporations of all kinds specified in the Act as subject to the tax were bound to file returns though their net profits were not sufficient to *render them liable to the tax* (U. S. v. Military Construction Co., 204 Fed. 153), and that the duty to make returns was not limited to those the net profits of which were sufficient to *render them liable to the payment of the tax.* (U. S. v. Acorn Roofing Co., 204 Fed. 157.)

engaged in business and may immediately file such return with the collector.[127]

EXTENSION OF TIME. A corporation desiring an extension of time within which to file its return should submit to the collector before the time for filing the return a tentative return and estimate on Form 1031 T, accompanied by a remittance of not less than one-fourth of the estimated amount of income and war-profits and excess-profits taxes for the taxable year. In such a case the collector may grant a reasonable extension of time for filing the complete return, not to exceed thirty days or, in the case of returns for 1918, not to exceed forty-five days after March 15, 1919.[128]

WHERE FILED. Corporate returns are filed with the collector of the district in which is located the principal place of business or principal office or agency of the corporation. If a domestic corporation keeps its books of account and other data in a foreign country and has no principal place of business or principal office in this country, the return should be made to the Collector of Internal Revenue in the district in which the corporation has its principal agency in this country.[129] If it has no such agency or branch office in this country, the return should be made to the collector of the district in which is located its statutory office; that is, the office required to be maintained in the state of incorporation in accordance with the statutes of that state.[130] It is to be noted that the return is not to be filed in the district in which is located the statutory office, unless the corporation has no principal place of business or principal office or agency from which the return can be filed. The purpose of designating the principal business office is for the convenience of the Treasury Department in examining the books of the corporation and verifying the return. Since the

127 Revenue Act of 1918, §§ 241 (a) and 227 (a).
128 See Chapter 34 on Returns.
129 Revenue Act of 1918, § 241 (b).
130 T. D. 2137.

statute now expressly designates the principal place of business or principal office or agency, the filing of a return from another office may not be considered a proper filing.[131]

By Whom Filed. Responsibility for filing corporate returns rests upon the principal officers of the corporation, although there is no penalty on such officers personally for failure to file returns. The only personal penalty on officers is for wilfully refusing to make the return, pay the tax, supply information required, or in any manner attempting to defeat or evade the tax.[132] In the case of corporations in the hands of receivers, trustees in bankruptcy or assignees, the corporate return is made by the receiver, trustee or assignee operating the property or business of the corporation in the same manner and form as corporations are required to make returns.[133] In the case of dissolved corporations, the return is filed by the directors or other persons in charge of the winding up of the corporation. Under the Corporation Act of New Jersey,[134] which provides that corporations however dissolved are "continued bodies corporate for the purpose of prosecuting and defending suits by or against them and of enabling them to settle and close their affairs," and constitutes the directors trustees to settle the business, the officers of a corporation which had been dissolved after becoming subject to the tax on its income of the preceding year, who were also its directors, were held to have

131 The 1916 Law required corporate returns to be made "to the collector of the district in which is located the principal office of the corporation, company or association, where are kept its books of account and other data from which the return is prepared." The 1913 Law was less explicit and might have been held to justify the filing of corporate returns from some other office, but the 1918 Law as well as the 1916 Law is open to no such construction.

132 Revenue Act of 1918, § 253.

133 Revenue Act of 1918, § 239; Reg. 45, Art. 622.

134 P. L. 1896, p. 295.

authority and to be under the duty of making the return of such business required by the 1909 Law.[135]

HOW PREPARED. All questions on the returns should be answered either by the insertion of figures or the insertion of the word "none."

SUPPLEMENTARY STATEMENT. The supplementary statement must be filled out in detail and no return which is not substantially correct in this respect will be accepted.[136] However, the division indicated in the supplementary statement on the corporation forms has been said by the Treasury Department to be merely suggestive. It desires information so far as possible in detail as to what items go to make up the general expense and if this information is sufficiently given in detail in a statement filed by the corporation with the Public Service Commission of its state the Treasury Department has no objection to such statement being attached to the return in lieu of filling out the supplementary statement.[137] If the books of any corporation are kept in such manner as to make it very difficult to give the information in the exact form called for in the supplementary statement a reasonable explanation in detail of the manner of arriving at gross income and expenses will be accepted. The information should be furnished in such manner that the returns can be intelligently audited by the Government.[138]

INCOME FROM MUNICIPAL, STATE OR NATIONAL BONDS. Although a corporation is not subject to tax on interest received from (a) obligations of a State or Territory or any political subdivision thereof or the District of Columbia; (b) securities issued under the Federal Farm Loan Act, (c) obligations of the United States (if issued after

135 U. S. v. General Inspection & Loading Co., 192 Fed. 223; 204 Fed. 657.

136 Mimeograph letter to Collectors No. 1148.

137 Letter from Treasury Department dated January 6, 1915; I. T. S. 1918, § 1777.

138 Letter from Treasury Department dated January 29, 1915; I. T. S. 1918, § 1783.

September 1, 1917) or its possessions or (d) obligations of the United States issued after September 1, 1917, and bonds issued by the War Finance Corporation to a limited extent of holdings therein, the Revenue Act of 1918 requires that a statement showing the number and amount of such obligations, securities and bonds owned by the corporation and the income received therefrom be submitted in the return of the corporation in such form and with such information as the Commissioner of Internal Revenue may require.[139] A similar requirement was imposed by regulation under the 1913 Law.[140]

How Signed and Sworn to. The return is required to be sworn to by the president, vice-president or other principal officer of the corporation and by the treasurer and assistant treasurer, and must be verified under the oath of such officers, except in the cases where the return is filed by a receiver, trustee, or assignee, or directors in the case of insolvency, in which cases the affidavit on the return should be changed in accordance with the facts.[141]

Consolidated Returns. Affiliated corporations are required to file consolidated returns on Form 1120. The consolidated return shall be filed by the parent or principal corporation in the office of the collector of the district in which it has its principal office. Each of the other affiliated corporations shall file in the office of the collector of its district Form 1122, along with the several schedules indicated thereon. The parent or principal corporation filing a consolidated return shall include in such return a statement specifically setting forth (a) the name and address of each of the subsidiary or affiliated corporations included in such return, (b) the par value of the total outstanding capital stock of each of such corpora-

139 Revenue Act of 1918, § 213 (b) 4, 233.

140 Letter from Treasury Department dated March 6, 1916, I. T. S. 1918, ¶ 1786. Reporting for the purpose of information of exempt interest by corporations was discontinued in later forms under the 1916 Law.

141 See Chapter 34 on Returns.

tions at the beginning of the taxable year, (c) the par value of such capital stock held by the parent corporation or by the same interests at the beginning of the taxable year, (d) in the case of affiliated corporations owned by the same interests, a list of the individuals or partnerships constituting such interests, with the percentage of the total outstanding stock of each affiliated corporation held by each of such individuals or partnerships during all of the taxable year, and (e) a schedule showing the proportionate amount of the total tax which it is agreed among them is to be assessed upon each affiliated corporation.[142]

Affiliated Corporations. The provision of the statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation. Where one corporation owns the capital stock of another corporation or other corporations, or where the stock of two or more corporations is owned by the same interests, a situation results which is closely analogous to that of a business maintaining one or more branch establishments. In the latter case, because of the direct ownership of the property, the invested capital and net income of the branch form a part of the invested capital and net income of the entire organization. Where such branches or units of a business are owned and controlled through the medium of separate corporations, it is necessary to require a consolidated return in order that the invested capital and net income of the entire group may be accurately determined. Otherwise opportunity would be afforded for the evasion of taxation by the shifting of income through price fixing, charges for services and other means by which income could be arbitrarily assigned to one or another unit of the group. In other cases without a consolidated return ex-

[142] Reg. 45, Art. 632; Revenue Act of 1918, Sec. 240.

cessive taxation might be imposed as a result of purely artificial conditions existing between corporations within a controlled group.[143]

WHEN CORPORATIONS ARE AFFILIATED. Corporations will be deemed to be affiliated (a) when one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (b) when substantially all the stock of two or more corporations is owned or controlled by the same interests. The words "substantially all the stock" shall be deemed to mean 95 per cent. or more of the outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year. When the stock ownership falls below 95 per cent., but is in excess of 50 per cent., a full disclosure of affiliations shall be made, and if it appears that the taxes can not be equitably assessed in such cases on the basis of separate returns, consolidated returns may be required. The words "by the same interests" shall be deemed to mean the same individual or partnership or the same individuals or partnerships, but when the stock of two or more corporations is owned by two or more individuals or by two or more partnerships a consolidated return is not required unless the percentage of stock held by each individual or each partnership is substantially the same in each of the affiliated corporations.[144]

143 Reg. 45, Art. 631.

144 Reg. 45, Art. 633. By regulations under the War Excess Profits Tax Law of 1917 two or more corporations were deemed to be affiliated "(1) when one such corporation owns directly or controls through closely affiliated interests or by a nominee or nominees, all or substantially all of the stock of the other or others, or when substantially all of the stock (95% or more of such stock, T. D. 2662) of two or more corporations is owned by the same individual or partnership, and both or all of such corporations are engaged in the same or a closely related business; or (2) when one such corporation (a) buys from or sells to another products or services at prices above or below the current market, thus affecting an artificial distribution of profits; or (b) in any way so arranges its financial relationships with another corporation as to assign to it

Change in Ownership During Taxable Year. When one corporation owns substantially all the stock of another corporation at the beginning of any taxable year, but during the taxable year sells all or a majority of such stock to outside interests not affiliated with it, or when one corporation during any taxable year acquires substantially all the capital stock of another corporation with which it was not previously affiliated, a full disclosure of the circumstances of such changes in ownership shall be submitted to the Commissioner. In accordance with the peculiar circumstances in each case the Commissioner may require separate or consolidated returns to be filed, to the end that the tax may be equitably assessed.[145]

Domestic Corporation Affiliated with Foreign Corporation. A domestic corporation which owns a majority of the stock of a foreign corporation shall not be permitted or required to include the net income or invested capital of such foreign corporation in a consolidated re-

a disproportionate share of net income or invested capital.'' Two or more corporations were not ''affiliated'' merely because all or substantially all of the stock therein was owned by the same corporation, individual or partnership; they were required also to be engaged in the same or a closely related business. For purposes of regulation by Public Service Commissions or similar authorities the identity of public service corporations, when not grouped into one operating unit, were required to be maintained, even though they were owned by the same corporation; and under such regulation the accounts of such public service corporations were deemed to reflect the true invested capital and income of each operating unit. Accordingly, railroads, gas, electric, water and other public service corporations when operated independently and not physically connected or merged—particularly when situated in different jurisdictions and subject to regulation by public service commissions—were not required or permitted without special permission obtained in advance, to make a consolidated return. When, however, a railroad or other public utility was owned by an industrial corporation and was operated as a plant facility or as an integral part of a group organization of affiliated corporations, and such affiliated corporations were required to file a consolidated return, the return of such railroad or other public utility was included therein. (T. D. 2662.)

145 Reg. 45, Art. 634.

turn,[146] but such domestic corporation may claim a credit for income, war-profits and excess-profits taxes paid by such foreign subsidiary in the manner and to the extent indicated in the chapter on credit for taxes.

Consolidated Net Income of Affiliated Corporations. Subject to the provisions covering the determination of taxable net income of separate corporations, and subject further to the elimination of intercompany transactions, the consolidated taxable net income shall be the combined net income of the several corporations consolidated. In respect of the statement of gross income and deductions and the several schedules required under Form 1120, a corporation filing a consolidated return is required to prepare and file such statements and schedules in columnar form to the end that the details of the items of gross income and deductions for each corporation included in the consolidation may be readily audited.[147]

Different Fiscal Years of Affiliated Corporations. In the case of all consolidated returns, consolidated invested capital must be computed as of the beginning of the taxable year of the parent or principal reporting company and consolidated income must be computed on the basis of its fiscal year.[148] Whenever the fiscal year of one or more subsidiary or other affiliated corporations differs from the fiscal year of the parent or principal corporation, the Commissioner should be fully advised by the taxpayer in order that provision may be made for assessing the tax

146 Reg. 45, Art. 636.

147 Reg. 45, Art. 637.

148 Under the 1917 War Excess Profits Tax Law it was held that the consolidated return should be made on the basis of the fiscal year of the parent company. As to past periods, the income of subsidiaries was to be computed to the date of the fiscal year of the parent company, and where the accounts did not disclose the profits earned as of such dates, estimates were accepted subject to a correct accounting at the close of the succeeding year. Letter from Treasury Department dated March 23, 1918; W. T. S. 1918, ¶ 913.

in respect of the period prior to the beginning of the fiscal year of the parent or principal company.[149]

Special Returns of Corporations. In addition to the above mentioned returns required to be filed by every corporation not exempt from tax, several special returns are required annually or at such times as the Commissioner of Internal Revenue may request of every corporation.

REPORT OF DIVIDEND PAYMENTS. Every corporation, including a personal-service corporation, when required by the Commissioner of Internal Revenue, is required to render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the tax years and the amount of dividends paid to him, in such form and manner as may be prescribed by the Treasury Department.[150] This return is for the purpose of supplying the Government with information against which the annual returns of stockholders may be compared, and is more fully covered in another chapter.[151]

REPORT OF INCOME PAYMENTS. All corporations, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries[152] and employers, making payment to any individual, corporation or partnership of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits and income (other than dividends and the payments described in the following paragraph) of or at the rate of $1,000 or more in any taxable year, are required to make returns in regard

149 Reg. 45, Art. 638.

150 Revenue Act of 1918, § 254. This section omits the catch-all phrase in modification of payments of dividends—"whether made in cash, its equivalent or in stock." See the definition of the term "dividend" in Revenue Act of 1918, § 201.

151 See Chapter 39 on Information at the Source. It will be noted in this provision the Commissioner is given discretion to require or not to require such returns.

152 See the definition of the term "fiduciary" in Chapter 8 on Fiduciaries.

thereto to the Commissioner of Internal Revenue under regulations of the Treasury Department, setting forth the amount of such payments and the names and addresses of the recipients. In the case of payments of interest upon its bonds, mortgages or deeds or trust or other similar obligations, such return is required from a corporation regardless of the amount paid.[153] This return is for the purpose of supplying the Treasury Department with information to be used in auditing the returns of the taxpayers to whom the income is paid, and is more fully discussed in a later chapter.[154]

REPORTS BY BROKERS. Every corporation doing business as a broker[155] is required, when called upon by the Commissioner of Internal Revenue, to make a return showing the names of its customers with such details as to the profits, losses or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner of Internal Revenue to determine whether all income tax due on the profits or gains of such customers has been paid.[156] This report is for the purpose of information at the source and is more fully discussed in a later chapter.[157]

Withholding the Tax at the Source. No withholding takes place on payment of income to domestic corporations. Such corporations are required to withhold the tax on payments of fixed or determinable annual or periodical gains, profits and income to non-resident aliens, and on payment of bond interest as indicated in another chapter.[158]

153 Revenue Act of 1918, § 256.

154 See Chapter 39 on Information at the Source.

155 The Revenue Act of 1918 omits the clause defining brokers, "on any exchange or board of trade or other similar place of business," which appeared in the 1916 Law.

156 Revenue Act of 1918, § 255.

157 See Chapter 39 on Information at the Source. It will be noted that under this provision the Commissioner is given discretion to require or not to require such returns.

158 See Chapter 40 on Collection of the Tax at the Source. Under

Foreign Items. Corporations undertaking as a matter of business and for profit the collection of foreign items are required to obtain a license in the manner more particularly set forth in another chapter.[159]

Examination of Corporate Records. All corporate books, papers, records or memoranda are subject to examination by any revenue agents or inspectors designated by the Commissioner of Internal Revenue for the purpose of ascertaining the correctness of returns which have been made, or making a return where none has been made, in accordance with and subject to certain rules which are discussed at length in another chapter.[160]

Penalties. Corporations or their officers or employees are subject in certain cases to penalties both specific and *ad valorem* for failing or refusing to make returns, supply information, pay or collect any tax or for willfully attempting in any manner to defeat or evade the income tax. Such penalties are more particularly discussed in another chapter.[161]

Personal-Service Corporations. Personal-service corporations,[162] as such, are not subject to the income tax, but their individual stockholders are taxed in the same manner as the members of partnerships. All provisions of the income tax relating to partnerships and the members thereof apply so far as practicable to personal-service corporations and their stockholders.[163]

Transportation Systems. For the purpose of the recent act[164] providing for the operation of transportation

the 1916 Law as amended corporations were required to withhold the tax on the dividend payments to non-resident foreign corporations, but this is no longer required.

159 Revenue Act of 1918, § 259. See Chapter 40 on Collection of the Tax at the Source.

160 See Chapter 37 on Examination of Taxpayers' Books.

161 See Chapter 36 on Penalties and Compromises.

162 The subject of personal service corporations is treated in full in Chapter 10 on Partnerships and Personal Service Corporations.

163 Revenue Act of 1918, § 218 (e).

164 Act of March 21, 1918.

systems while under Federal control five-sixths of the tax —or a tax of 10%—on the net income of corporations in excess of credits for the calendar year 1918, and four-fifths of the tax—or a tax of 8%—on the net income of corporations in excess of credits for each calender year thereafter, is treated as levied by an act in amendment of Title I of the Revenue Act of 1917.[165] The act providing for the operation of transportation systems while under Federal control and for the just compensation of their owners provided that every agreement entered into pursuant thereto between the President and the transportation systems covering the operation thereof while under Federal control and the just compensation of the owners thereof should provide that any Federal taxes "under the Act of October third, nineteen hundred and seventeen, or acts in addition thereto or in amendment thereof, commonly called war taxes," assessed for the period of Federal control beginning January 1, 1918, or any part of such period, should be paid by the carrier out of its own funds or charged against or deducted from the just compensation stipulated in the agreement. Other taxes assessed under Federal or any other governmental authority for the period of Federal control or any part thereof either on the property used or on the right to operate as a carrier or on the revenues or any part thereof derived from operation (not including, however, assessments for public improvements or taxes assessed on property under construction and chargeable under the classification of the Interstate Commerce Commission to investment in road and equipment) are provided to be paid out of revenues derived from railway operations while under Federal control. All taxes assessed under Federal or any other governmental authority for the period prior to January 1, 1918, whenever levied or payable are provided to be paid by the carrier out of its own funds or charged against or deducted from the just compensation. The 4% tax levied

165 Revenue Act of 1918, § 230 (b).

under the 1917 Law is paid by the carrier out of its own funds or charged against or deducted from the compensation payable to the carrier, whereas the 2% tax imposed by the 1916 Law is paid out of revenues derived from railway operations while under Federal control. The tax on all income payable by the carrier on its income arising in the calendar year 1918 and subsequent years in excess of the 2% levied under the 1916 Law is accordingly to be paid by the carrier out of its own funds or charged against or deducted from any compensation it may receive by reason of government operation since such excess is treated as levied by the act in amendment of "the Act of October third, nineteen hundred and seventeen or acts in addition thereto or in amendment thereof, commonly called war taxes."[166]

[166] Act of March 21, 1918. This Act also provides: "That moneys and other property derived from the operation of the carriers during Federal control are hereby declared to be the property of the United States. Unless otherwise directed by the President, such moneys shall not be covered into the Treasury, but such moneys and property shall remain in the custody of the same officers, and the account thereof shall be in the same manner and form as before Federal control. Disbursements therefrom shall, without further appropriation, be made in the same manner as before Federal control and for such purposes as under the Interstate Commerce Commission classification of accounts in force on December twenty-seventh, nineteen hundred and seventeen, are chargeable to operating expenses or to railway tax accruals and for such other purposes in connection with Federal control as the President may direct, except that taxes under Titles One and Two of the Act entitled 'An Act to provide revenue to defray war expenses, and for other purposes,' approved October third, nineteen hundred and seventeen, or any Act in addition thereto or in amendment thereof, shall be paid by the carrier out of its own funds. If Federal control begins or ends during the tax year for which any taxes so chargeable to railway tax accruals are assessed, the taxes for such year shall be apportioned to the date of the beginning or ending of such Federal control, and disbursements shall be made only for that portion of such taxes as is due for the part of such tax year which falls within the period of Federal control."

NOTE 167

Interest Deduction by Corporations under the Revenue Act of 1916.

Under the 1916 Law, as amended, a corporation might deduct the amount of interest paid within the year on its indebtedness (except indebtedness incurred for the purchase of obligations or securities, the interest upon which was exempt from taxation as income under the law) to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (b) one-half of its interest-bearing indebtedness then outstanding. In the case of interest paid on indebtedness wholly secured by property collateral, tangible or intangible, the subject of sale or hypothecation in the ordinary business of the corporation, as a dealer only in the property constituting such collateral, or in loaning the funds thereby procured, the total interest might be deducted as a part of the expense of doing business, on an amount of such indebtedness not in excess of the actual value of such property collateral. (Revenue Act of 1916, § 12.)

Reason for the Limitation. This arbitrary limitation upon the amount of interest deductible by a corporation was a survival of a provision of the 1909 Law, which imposed an excise tax on corporations measured by the amount of income. In construing the 1909 Law the Supreme Court held that it was not in any proper sense an income tax law, but was an excise tax upon the conduct of business in a corporate capacity, the tax being measured by reference to the income. In limiting the amount of interest which a corporation could deduct under that law Congress evidently had in view the fact that some corporations carry a current indebtedness exceeding the amount of paid up capital stock and with respect to such corporations intended to limit the interest deduction to so much of the indebtedness as did not exceed the capital. It appears that Congress deemed that where the indebtedness exceeded that capital it should no longer be treated as an incident, but should be considered as a principal object of the corporate activities, and that the operations of such a corporation were conducted more for the benefit of the creditors than of the stockholders. There is no question of the power of Congress to adopt such a basis of distinction. (Anderson v. 42 Broadway Co., 239 U. S. 69, reversing 213 Fed. 777.) While the reason for such arbitrary limitation was excellent in the case of a tax such as that imposed by the 1909 Law, which could otherwise have been avoided by the conversion of capital into indebtedness, the reason applies with much less force to the 1916 Law where the income which was not taxed to the corporation became

taxable to the bondholder. To the extent, therefore, that a corporation was not permitted to deduct all of the interest paid on its indebtedness such interest was subject to tax both to the corporation and to the bondholder. This did not throw a double burden on the bondholder, but threw an extra burden on the stockholders of the corporation who were deprived of earnings to the extent that interest paid to bondholders was taxed to the corporation. The arbitrary limitation resulted in the creation of a fictitious income on which the corporation was taxed, and since such fictitious income not only was subject to a heavy income tax but entered very materially into the computation of an extraordinarily heavy excess profits tax, the provision operated with rank injustice in the case of corporations which had an indebtedness greatly in excess of their capital stock. In fact, it seems inevitable that real estate corporations such as the Forty-two Broadway Co., which raised the question under the 1909 Law, would, under the 1916 income tax and excess profits tax laws, incur such heavy tax burdens as to place them in grave danger of insolvency.

Interest-Bearing Indebtedness. The interest-bearing indebtedness referred to in this provision of the 1916 Law did not include preferred capital stock; interest or dividends paid upon such stock was not deductible from gross income. (Revenue Act of 1916, § 12.) It did not include indebtedness secured by collateral subject to sale. Under the 1909 Law, if a corporation took title to real property subject to a mortgage but did not assume the indebtedness secured thereby, the interest could be deducted in full, as this would not be a payment by the corporation owning the property subject to such lien on its own indebtedness, because the indebtedness was not its bonded or other indebtedness, but an indebtedness created by a third party and charged as a lien upon the land acquired, subject thereto, by the purchasing corporation. (28 Op. Atty. Gen. 198.) But the 1916 Law did not permit of this construction since it provided that "payments required to be made as a condition to the continued use or possession of property," as the phrase appeared in the 1909 and 1913 Laws, must be with respect to property "to which the corporation has not taken or is not taking title or in which it has no equity." Where a corporation purchased property encumbered by a mortgage or other lien and the amount thereof was a part of and included in the purchase price, upon the payment of which the title vested absolute in the purchaser, the purchaser assumed the indebtedness on the property thus purchased and interest thereon partook in no degree of the nature of rental or franchise charges and its deduction was limited by the provisions of law. (T. D. 1865.) If a corporation had an equity in or was purchasing for its own use the real estate upon which a mortgage was a prior lien and the corporation assumed the payment of

interest, the indebtedness was held to be indebtedness of the corporation and interest paid on such mortgage was deductible only within the limit fixed by the law. (Reg. 33, Art. 148.) A corporation, which did a brokerage business and bought securities for its customers, who paid only a part of the purchase price, paying interest on balances, the corporation also paying for the securities purchased only part of the purchase price and owing balances on which it paid interest, including in return of gross income the difference between the interest received and the interest paid, was held to have made an incorrect return. The interest received by the corporation from its customers should have been included in gross income. In determining net income, interest could be deducted only to an amount not exceeding the paid-up capital stock outstanding at the close of the year. (Altheimer & Rawlings Investment Co. v. Allen, 246 Fed. 270, petition for a writ of certiorari denied November 18, 1918; Middlesex Banking Co. v. Eaton, 233 Fed. 87; T. D. 2441.)

Indebtedness Bearing Different Rates of Interest. Where a corporation had several classes of indebtedness bearing different rates of interest and the aggregate amount of indebtedness exceeded the limit allowed by law, the indebtedness bearing the highest rate might be first considered in computing the interest deduction, and the balance, if any, computed on the indebtedness bearing the next lower rate and so on until the interest on the maximum principal allowed was computed. (Reg. 33, Art. 151.)

Indebtedness Outstanding at Close of the Year. From the amount of indebtedness to be reported as indebtedness outstanding at the close of the year was required to be eliminated all indebtedness incurred in the purchase of securities the income from which was not subject to the income tax. (Reg. 33 Rev., Art. 95.) Such amount should not include indebtedness which was not bearing interest. If no indebtedness was outstanding at the close of the year, the maximum deduction allowable on account of interest paid would be measured by an amount of indebtedness not exceeding at any time within the year the entire paid up capital stock outstanding at the close of the year; that is, in such case the capital stock outstanding at the close of the year measured the highest amount of indebtedness upon which deductible interest could be computed. (T. D. 1960.) Where the indebtedness of a corporation varied from month to month so that during portions of the year the interest-bearing indebtedness outstanding was greatly in excess of the maximum principal upon which interest could be calculated and in other portions of the year less than such maximum principal, the corporation was limited to a deduction which represented the amount of interest actually paid during the year but *at all times within the limitation fixed by law*, and was not allowed to deduct the total amount of interest paid

during the year, even though at the rate of interest paid (6%) such amount was less than 6% of the maximum principal. (Letter from Treasury Department dated April 29, 1918; I. T. S., 1918, ¶ 3344.)

Paid Up Capital Stock Outstanding at the Close of the Year. This phrase meant the par value of shares issued as reported in Item 1 of the return form and did not include the surplus carried by the corporation. The full amount of stock represented by the par value of the shares issued was regarded as the paid up capital stock, except when such stock was assessable on account of deferred payments, or payable in installments, in which case the amount actually paid on such shares constituted the actual paid up capital stock. (T. D. 2090; Reg. 33, Art. 95.) Where the capital stock of the corporation was issued without par or nominal value, the law provided that the amount of capital stock as represented by such shares would be the amount of cash or its equivalent paid or transferred to the corporation as a consideration for such shares. If such shares were issued as a bonus in connection with shares of preferred stock, the par value of the preferred stock would be the limit which might be claimed as paid up capital stock. If both common and preferred were issued for cash or other equivalent consideration, the amount would be the par value of the preferred stock plus the amount actually paid in on the shares issued without par value. (Letter from Treasury Department dated January 13, 1916; I. T. S. 1918, ¶ 1767.) Neither in the case of stock issued with a par value nor in the case of stock issued without par value could the amount of paid up capital stock be increased except as new capital was paid in and for which additional shares were issued. (Letter from Treasury Department dated January 13, 1916; I. T. S. 1918, ¶ 1767.)

Interest Paid by Banks on Deposits. In the case of a bank, banking association, loan or trust company, the interest paid on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank, banking association, loan or trust company was permitted to be deducted in full. Where a corporation, chartered as a bank, was engaged in the business of selling debenture bonds and guaranteed real estate securities, by a method by which it both paid and received interest, it was held under the 1909 Law that the interest paid out could not be deducted in full as interest paid on deposits, the transaction in no way being a banking transaction. (Middlesex Banking Co. v. Eaton, 233 Fed. 87.) Such interest could probably be deducted as interest paid on indebtedness secured by collateral.

Car Trust Certificates. Railroad companies were permitted to include these trust certificates in the amount of their bonded or other indebtedness reported. (Reg. 33 Rev., Art. 188.)

Interest on Indebtedness Secured by Collateral. The deduction of such interest was permitted without limit provided (a) the indebtedness was wholly secured by property collateral, tangible or intangible, (b) the collateral was the subject of sale or hypothecation in the ordinary business of the corporation as a dealer in such property or in loaning the funds thereby produced and (c) the indebtedness did not exceed the actual value of such property collateral. Such interest was deductible not as interest paid, but as an expense of doing business. The deduction was required to be stated separately in the return of annual net income and was required to be segregated from indebtedness not so secured. Failure to segregate the two forms of indebtedness resulted in a suspension or disallowance of the amount claimed. (T. D. 1993.)

Collateral the Subject of Sale. This phrase as used in the law referred to tangible or intangible property bound for the performance of certain covenants or payment of certain obligations. Real estate owned and mortgaged by corporations organized for and engaged in the business of buying, selling and dealing in real estate, warehouse receipts representing property the subject of sale in the ordinary business of the corporations owning same, and which warehouse receipts were pledged as collateral for such corporations' own debt, were examples where the interest would be deductible without limit. (T. D. 2090.) If a corporation whose ordinary business was the purchase and sale of real estate had an office building under mortgage, which office building was not subject to sale in the ordinary business of the corporation, the interest paid on such mortgage might not be deducted without limit. (T. D. 2137.)

As a Dealer Only. The only corporations allowed under this proviso to deduct interest in full were those organized and operated for the purpose of buying, selling and dealing in the particular kind of property upon which the mortgage was given, and the particular property pledged for the debt upon which the interest was paid was required to be the subject of sale in the ordinary business of the corporation. (T. D. 1993.)

Ordinary Business of the Corporation. Where a corporation dealt in the property serving as collateral for the indebtedness as a matter of its ordinary business, deduction might be made in full, but where the property was held by it for the purpose of, or as an instrument in carrying on, its ordinary business such as the rights of way and other property of public utility companies, permanent office buildings and property of like character held or occupied for the particular use or purpose or the furtherance of the objects of the corporation, the property was held not to be the subject of sale in its ordinary business, but to be occupied or used as an instrument of carrying on the ordinary business for the transaction of which the corporation was organized. The fact that such property might be subject to sale under extraordinary or peculiar conditions did not qualify it as collateral. (T. D. 1993.)

CHAPTER 13

SPECIAL PROVISIONS APPLYING TO INSURANCE COMPANIES

In the case of insurance companies, both domestic and foreign, certain special provisions govern the calculation of gross income and the making of deductions.[1] In general domestic insurance companies are subject to the same provisions as other domestic corporations and foreign insurance companies are subject to the same provisions as other foreign corporations. The foregoing chapter should be consulted as to the general provisions relating to corporations and the following chapter should be consulted as to the special provisions applicable to foreign corporations. Under the 1916 Law two special forms for making the return of income were provided for insurance companies, one to be used by mutual insurance companies other than mutual life and mutual marine, and the other to be used by all other insurance companies including mutual life and mutual marine.[2]

Gross Income. The gross income of insurance companies is determined in the same manner as in the case of other corporations except that (a) in the case of life insurance companies it does not include such portion of any annual premium received from any individual policy holder as is paid back or credited to or treated as an abatement of premium of such policy holder within the taxable year and (b) in the case of mutual marine insurance companies it does include the gross premiums collected and received by such companies less amounts paid for rein-

1 Revenue Act of 1918, §§ 233 (a) 1 and 2, 234 (a) 10, 11, 12 and 13.

2 Forms No. 1030 and 1030A.

surance.[3] Gross income includes net premiums, investment income, income from the sale of capital assets, and all gains, profits and income reported to the State insurance departments, except income specifically exempt from tax. Amounts of premium received and paid out under reinsurance treaties should be eliminated from both income and disbursements. Deposit premiums on perpetual risks received and returns should be treated in the same manner, as no reserve will be considered covering liability for such deposits, but the earnings on such deposits will be included in the investment income. A net decrease in reserve funds within the taxable year must be included in the gross income.[3a]

Expenses. The same allowance for expenses is permitted as in the case of other corporations. Insurance companies will be permitted to add to expenses, in lieu of depreciation of furniture and fixtures, the actual cost of repairs, replacements and renewals of such furniture, as is reported to the state insurance department, provided that in the case of an original investment, the cost thereof shall be charged to capital account.[4]

Deduction of Net Addition to Reserve Funds. Insurance companies may deduct the net addition required by law to be made within the taxable year to reserve funds. This is considered to mean the net addition required by the specific statutes of the states within which the taxpayer transacts business.[5] The net addition may be based upon the highest authorized reserve required by the statutes of any state in which the company does business, but having adopted the requirements of one state the company cannot base its reserve upon the requirements of another state for subsequent years.[6] Only reserves commonly recognized as reserve funds in insurance account-

[3] Revenue Act of 1918, § 233 (a) 1 and 2.
[3a] Reg. 45, Art. 546; Reg. 33 Rev., Art. 239.
[4] Reg. 33 Rev., Art. 240.
[5] Reg. 45, Art. 570.
[6] T. D. 1727; Reg. 33 Rev., Art. 240.

ing are to be taken into consideration in computing the net addition to reserve funds required by law. In the case of a fire insurance company the only reserve fund commonly recognized is the "unearned-premium" fund. The net addition to the fund maintained to pay incurred losses is not a legal deduction from gross income. In the case of casualty companies reserve funds consist of amounts maintained to meet the "unearned-premium" liability and the "unpaid-loss" liability. In the case of life insurance companies the net addition to the "reinsurance reserve" and the "reserve for supplementary contracts not involving life contingencies," and the net addition to any other reserve funds necessarily maintained for the purpose of liquidating policies at maturity, are legally deductible. An increase in the amount maintained by a life insurance company to pay dividends on deferred dividend policies may not be deducted from gross income. An assessment insurance company is entitled to deduct from gross income the increase in the amount which it is required by law to keep on deposit with State insurance departments as a protection to policyholders. Mutual hail and mutual hail and cyclone insurance companies are entitled to deduct from gross income the net addition which they are required to make under the laws of the states in which they operate to the "guaranty surplus" fund or similar fund.[6a] The income tax law specifically limits the deductions to sums required by law, not such reservations as business prudence may suggest, and the express provisions of the law fix the determining basis.[7]

RESERVES REQUIRED BY LAW. As a general rule, only those reserves which are "required by law" may be deducted. Under the laws of Pennsylvania reserves against unpaid losses are required by law of casualty companies, but not of fire and marine insurance companies. Hence,

[6a] Reg. 45, Art. 570.

[7] Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201; T. D. 2451. This case is now No. 395 on the docket of the United States Supreme Court.

the latter cannot deduct reserves against losses, although the Insurance Commissioner of Pennsylvania may require such reserves under a practice of his office established for many years and relied upon as an administrative interpretation of the law of that state.[8] Corporations issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, may deduct such portion of the net addition (not required by law) made within the taxable year to reserve funds as the Commissioner of Internal Revenue finds to be required for the protection of the holders of such policies only.[9]

RELEASED RESERVES. Where there has been a decrease in reserve funds the amount of the decrease is commonly called released reserve, and is to be treated as income for the year in which the reserve is released.[10] Released reserves though not mentioned in express terms in the law have been held to be income and taxable for the year in which released.[11]

Assessment Insurance Companies. In the case of assessment insurance companies the actual deposit of sums with state or territorial officers pursuant to law as additions to guarantee or reserve funds are included in the term "the net addition required by law to be made within the taxable year to reserve funds." [12]

Payments on Policy and Annuity Contracts. All insurance companies may deduct the sums, other than dividends, paid within the taxable year on policy and annuity contracts.[13] Under this item on the return of income may be included all death, disability or other policy claims, including fire, accident and liability losses, matured endow-

[8] Insurance Company of North America v. McCoach, 218 Fed. 905, reversed 224 Fed. 657, 661, writ of certiorari granted, 241 U. S. 694, reversed 244 U. S. 585; see T. D. 2501.

[9] Revenue Act of 1918, § 234 (a) 11.

[10] Reg. 33 Rev., Art. 240.

[11] Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201; T. D. 2451.

[12] Revenue Act of 1918, § 234 (a) 10.

[13] Revenue Act of 1918, § 234 (a) 10.

ments, payments on installment policies, surrender values and all claims actually paid under the terms of policy contracts. There may also be deducted as losses agency balances or other amounts charged off, losses from defalcation, and premium notes voided by lapse provided such notes have at some time been included in returns of income.[14]

Mutual Insurance Companies. Under the 1916 Law it was provided that "mutual fire and mutual employers' liability and mutual workmen's compensation and mutual casualty insurance companies requiring their members to make premium deposits to provide for losses and expenses shall not return as income any portion of the premium deposits returned to their policyholders, but shall return as taxable income all income received by them from all other sources plus portions of their premium deposits as are retained by the companies for purposes other than the payment of losses and expenses and reinsurance reserves."[15] The Revenue Act of 1918 provides[16] that in the case of mutual insurance companies (other than mutual life or mutual marine insurance companies) there shall be allowed in addition to other deductions "the amount of premium deposits returned to their policyholders and the amount of the premium deposits retained for the payment of losses, expenses, and reinsurance reserves." It will thus be noted that in the case of such companies the amount of premium deposits returned to policyholders will not be excluded from gross income, as heretofore, but will be included therein, and taken as a deduction; and this will also be true of such portions of their premium deposits as are retained for the payment of losses, expenses and reinsurance reserves. Under the above quoted provision of the 1916 Law, the Treasury Department prescribed a special form for such companies.[17] It was ruled under

14 Reg. 45, Art. 569.
15 Revenue Act of 1916, § 12 (a).
16 Revenue Act of 1918, § 234 (a) 13.
17 This form was known as No. 1030A.

the 1916 Law as to such insurance companies as stated in the following paragraph.

PROFIT ON SALE OR MATURITY OF LEDGER ASSETS. Under the 1916 Law, the profit or income to be returned in the event of the sale or maturity of capital assets acquired prior to March 1, 1913, was required to be determined upon the basis of the difference between the fair market value of such assets as of that date and the selling price thereof. If the assets were acquired subsequent to March 1, 1913, the loss would be the amount by which the selling price was less than the *cost*. This profit or income might, for the purpose of the tax, be reduced by the amount of any loss resulting from the same source and ascertained in the same manner. In no event could a loss resulting from the sale or maturity of capital assets exceed the gain within the year from like transactions.[18]

Mutual Marine Insurance Companies. Mutual marine insurance companies are required to include in gross income the gross premiums collected and received by them less amounts paid for reinsurance,[19] but are entitled to deduct from gross income amounts repaid to policyholders on account of premiums previously paid by them, and interest upon such amounts between the ascertainment and the payment thereof.[20] In other respects the companies of this class proceed in the same manner as insurance companies generally.

Life Insurance Companies. Life insurance companies, including stock and mutual companies, do not include in gross income such portion of any actual premium received from any individual policyholder as is paid back or credited to or treated as an abatement of premium of such policyholder within the taxable year.[21] In so far as "deferred

18 Reg. 33 Rev., Art. 242.

19 Revenue Act of 1918, § 233 (a) 2.

20 Revenue Act of 1918, § 234 (a) 12; Reg. 45, Art. 569.

21 Revenue Act of 1918, § 233 (a) 1; Reg. 33 Rev., Art. 241. Under the 1909 Law there was much litigation as to whether so-called dividends paid by insurance companies to policyholders as

dividends" payable at a stated period represent "a portion of any actual premium received," they may be omitted from gross income for the year in which they were actually paid back, except that so much of any deferred dividends paid during the tax year to the individual policyholder as exceeds the amount of premiums paid during the same year may not be omitted. Only the actual amount of dividends actually credited or apportioned to a policyholder during the premium-paying period, and not any accretions thereto, can be excluded from gross income. In the case of whole life or five-year distribution policies, deferred dividends may be excluded from gross income to the extent that they are paid back or credited to the insured or used as an abatement of annual premiums.[22] Dividends provisionally ascertained, apportioned, or credited on deferred dividend policies cannot be excluded from gross income for the reason that the assured has no vested or enforceable right in them and cannot, at the time of the ascertainment, apportionment, or credit, nor until the maturity of the policy, avail himself of such dividends; and in the event of the death of the assured prior to the expiration of the deferred dividend period, the amount so ascertained, apportioned, or credited lapses.[23] Book income of life insurance companies which consists of "dividends applied to purchase paid-up additions and annuities," "dividends applied to pay renewal premiums," and "dividends applied to shorten the endowment or premium-paying period," shall not be included in gross income except when the dividends applied are declared on paid-up participating policies.[23a]

a return of a part of the premium were properly deductible. The courts held that the so-called dividends awarded annually to policyholders did not constitute income (Herold v. Mutual Benefit Insurance Co., 201 Fed. 918, affirming 198 Fed. 199) and at the time of the enactment of the 1913 and 1916 Laws the point was expressly covered by substantially the same language as in the present law.

[22] Reg. 33, Art. 100.

[23] Reg. 33 Rev., Art. 241.

[23a] Reg. 45, Art. 547.

Supplementary Policy Contracts. Where a life insurance company's policies contain an option to have proceeds paid in annual installments for a given term of years, or during the lifetime of the beneficiary, instead of in one sum, such policies, if the option is exercised, are styled "supplementary policy contracts." These obligations are protected by reserves, the net additions to which are deductible if such reserves are "required by law." The Commissioners of Insurance of all the states require the establishment of a reserve to cover the obligations of the company on such supplementary policy contracts. This fact of itself tends strongly to show that they are required by law,[24] but if the action of a commissioner of insurance is based in such cases upon the practice of his office and not upon an express requirement of law, deduction may not be made.[25]

Payments on Policies. Surrender values applied in any manner, consideration for supplementary contracts, involving and not involving life contingencies, should be included in the gross income of life insurance companies. Applied surrender values and consideration for supplementary contracts not involving life contingencies included in income are deductible as payments under policy contracts, but for convenience in verifying the returns these items should appear in the return in gross income and deductions.[26]

Mutual Life Insurance Companies. Mutual life insurance companies file the same return as stock companies and are governed by the same rules with respect to computing net income. It has been held that portions of premiums and accretions received by mutual life insurance companies and returned to policyholders may be excluded from gross income for the year in which they are returned, the fact being that in the case of such companies the actual cost

24 Mutual Benefit Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918.

25 See Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201; T. D. 2451. See Note 7.

26 Reg. 33 Rev., Art. 241.

only of insurance is paid by the policyholders. Such returns of parts of the premiums paid with interest are merely periodic refunds of excess amounts paid in.[27]

Returns of Insurance Companies. Insurance companies transacting business in the United States or deriving an income from sources therein are required to file returns of income. The return shall be on Form 1120. The returns of insurance companies must be rendered in conformity with the reports made for the same period to State insurance departments. As an aid in auditing the returns, wherever possible a copy of the report to the State insurance department should be submitted with the return. Otherwise a schedule should be attached thereto showing the federal, State, and municipal obligations from which the interest omitted from gross income was derived.[28]

Foreign Insurance Companies. Foreign insurance companies are required to report as gross income only the gross income from all sources within the United States. Under the present law it seems income from the possessions of the United States need not be included. Income from business transacted by a United States branch or agency of a foreign insurance company which relates to a foreign country must be returned as gross income.[29]

Mutual Employers' Liability Insurance Companies. The 1916 Law included companies of this class in the same class as mutual fire insurance companies and the statement in the preceding paragraphs regarding mutual insurance companies applies to this class of companies, both under the 1916 Law and the Revenue Act of 1918.

Mutual Workmen's Compensation Companies. The 1916 Law included companies of this class in the same class as mutual fire insurance companies and the statement in the preceding paragraphs regarding mutual insurance companies applies equally to this class of companies, both under the 1916 Law and the Revenue Act of 1918.

27 Penn. Mut. Life Ins. Co. v. Lederer, 247 Fed. 559.

28 Reg. 45, Art. 623.

29 Revenue Act of 1918, § 233 (b); Reg. 33 Rev., Art. 244.

Mutual Casualty Insurance Companies. The 1916 Law included companies of this class in the same class as mutual fire insurance companies and the statement in the preceding paragraphs regarding mutual insurance companies applies equally to this class of companies, both under the 1916 Law and the Revenue Act of 1918.

CHAPTER 14

FOREIGN CORPORATIONS

The Revenue Act of 1918 provides that the income tax shall be levied, collected and paid for each taxable year upon the net income received from sources within the United States by every corporation created or organized outside of the United States, including (1) interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise, (2) dividends from resident corporations and (3) all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture *and* disposition of goods within the United States.[1] The deductions per-

[1] Revenue Act of 1918, §§ 230 (a), 233 (b), 200. The 1916 law provided that the income tax should be levied, assessed, collected and paid annually upon the total net income received in the preceding calendar year from all sources within the United States by every corporation, joint-stock company or association or insurance company, organized, authorized or existing under the laws of any foreign country including interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise, and including the income derived from dividends on capital stock or from net earnings of resident corporations, joint-stock companies or associations, or insurance companies, whose net income was taxable for income tax purposes (Revenue Act of 1916, § 10 (a)). Under the 1913 law foreign corporations were taxable only upon the income accruing from business transacted *and* capital invested within the United States. Interest and dividends received by foreign corporations were held to be income from capital invested in this country. Although at first it was held under that law that interest and dividends received by non-resident alien individuals were not subject to tax, after the decision in the case of Brushaber v. Union Pacific Railway Company, 240 U. S. 1, the Treasury Department

mitted to foreign corporations are in general the same as those permitted to domestic corporations, but, with the exception of interest and taxes paid or accrued within the taxable year, are allowed only if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States are determined under rules and regulations prescribed by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury.[2] It will be noted that the Revenue Act of 1918 expressly includes amounts received representing profits on the manufacture *and* disposition of goods within the United States. Income from rentals and royalties from property, income from business carried on in the United States, income from isolated transactions or activities directly resulting in gain carried on within the Unted States by a foreign corporation or its representative, interest on deposits in banks located within the United States and income from capital otherwise invested in the United States and from services rendered or labor performed within the United States is also included within the term "sources within the United States."

Definitions. As used in this chapter, the term "foreign corporation" means a corporation, association, joint-stock company or insurance company created or organized outside the United States[3] including only the states, the territories of Alaska and Hawaii and the District of Columbia. Foreign corporations are divisible into four classes, designated as follows: (1) "non-resident foreign corporations" are those which have no office or place of business in the United States; (2) "non-resident foreign cor-

changed its rulings and held that interest and dividends so received were subject to the tax, whether the recipient was an individual or a corporation. (T. D. 2313.)

[2] Revenue Act of 1918, § 234 (b).

[3] See Revenue Act of 1918, § 1; Reg. 45, Art. 1508.

porations with a branch in the United States,'' are those which have their principal or head business office in a foreign country but incidentally have branch offices or places of business in the United States; (3) "resident foreign corporations'' are those which have their principal or head business office in the United States and do business solely in this country, and (4) "resident foreign corporations having branches outside the United States'' are those which have their principal or head business office in the United States, but incidentally have branch offices or places of business outside the United States.[4] In this chapter, however, a foreign corporation engaged in trade or business within the United States or having an office or place of business therein will be referred to as a resident foreign corporation and a foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein will be referred to as a non-resident foreign corporation.[5] The term "source,'' as used in this chapter, means the place of origin of income.[6] The term "taxable year,'' as used in this chapter, means the calendar year or the fiscal year ending during such calendar year upon the basis of which the net income is computed.[7]

Corporations Exempt from the Tax. The corporations enumerated in the law as exempt[8] include foreign corporations as well as domestic corporations, except as stated in the chapter on exempt organizations.[9]

Corporations Subject to the Tax. All foreign corporations receiving income from sources within this country and not specifically exempt, as indicated in the preceding paragraph, are subject to the tax. It is not necessary

4 See T. D. 2401; Reg. 33 Rev., Art. 200.

5 Reg. 45, Art. 1508.

6 Reg. 33 Rev., Art. 66.

7 Revenue Act of 1918, § 200. For definition and discussion of the term "fiscal year'' see Chapter 12 on Corporations and Chapter 34 on Returns.

8 Revenue Act 1918, § 231.

9 See Chapter 15 on Exempt Organizations.

that foreign corporations should be engaged in business in this country or that they have an office branch or agency in the United States. Liability to the income tax attaches with respect to the income, the source of which is in the United States.[10]

Sale of Goods by Correspondence. No attempt was made to impose the 1916 tax on transactions in which a foreign corporation sells goods in this country by correspondence, or delivers goods so sold to a citizen or resident of this country. The conclusion seemed to be that such sales did not create any income from sources within the United States where the contract for the sale of goods was made in a foreign jurisdiction, whether the title to the goods passed in the foreign jurisdiction or title was retained after the goods arrived in this country until payment therefor had been made. Where, however, a resident of this country pays interest on any deferred payments of purchase price the interest is clearly subject to tax under the express provisions of the 1916 and the 1918 Law.[11] The provision of the Revenue Act of 1918 that gross income shall include, in the case of foreign corporations, all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture *and* disposition of goods within the United States seems to impose a tax on the profits arising from the sale in this country of goods which have been manufactured here. The ruling of the Treasury Department under this provision of law refers to profits on the "manufacture *or* disposition of goods within the United States" as being income from sources within the United States,[12] but the use of the disjunctive particle "or" broadens the sense of the phrase and is a doubtful interpretation of the language of the statute in view of the general rule of construction of taxing statutes that in case of doubt the language will be construed in favor of the taxpayer.

10 Reg. 33 Rev., Art. 66.
11 Revenue Act of 1916, § 10 (d); Revenue Act of 1918, § 233 (b).
12 Revenue Act of 1918, § 233 (b); Reg. 45, Art. 91.

Traveling Salesmen. The Treasury Department has held as follows: Where a foreign corporation sends a representative to this country to solicit business, the merchandise thus sold to be shipped direct to the consignee, the corporation is transacting business in this country. The fact that the solicitor or representative has only a mailing address in this country is immaterial, as he is none the less an agent of the foreign corporation. To the extent that he sells in this country goods or merchandise for the foreign corporation, to that extent the foreign corporation is transacting business in the United States and is required to make a return to the collector in the district in which its representative has his mailing address.[13] An agent who is doing business in this country, buying and selling certain products of the foreign corporation, is to all intents and purposes a branch of the foreign corporation as through and by him the foreign corporation is transacting business here. The buying and selling of products in this country through a local agency or branch is clearly transacting business here.[14] Under the 1913 Law it was held that a foreign corporation was subject to the tax on income accruing from business transacted and capital invested within the United States, where (a) it sent agents into the United States to solicit purchasers for its products, hiring desk room in the United States and empowering the salesmen to make written contracts, (b) shipped its product consigned to itself in the United States to different points where it hired storage rooms and stored the product in its own name and at its own risk to insure delivery according to contract, and to meet anticipated demands.[15]

13 T. D. 2161.

14 T. D. 2137.

15 Laurentide Co. Ltd. v. Durey, 231 Fed. 223. The court said in part: "I think it would be somewhat difficult for the Laurentide Co., Ltd., or its able attorney, to describe what it was doing in the United States, if it was not doing, carrying on and transacting business therein, when there receiving large quantities of newspaper, consigned to itself and storing it, hiring and paying for storage

Foreign Steamship Companies. Foreign steamship companies engaged in the business of transporting passengers, goods and merchandise between ports in this country and foreign ports and maintaining passenger and freight agencies in this country, are doing business here and subject to the income tax. There seems to be no question of constitutionality involved in such tax being a tax on exports.[16] A foreign corporation is not subject to tax on charter money for a vessel operated between the United States and foreign ports if the making of the charter contract grows out of no solicitation or similar commercial activity of a representative in person in the United States.[17] Foreign steamship companies having no office in the United States, whose vessels only occasionally touch at ports in the United States, were not regarded as doing business in this country within the meaning of the 1909 Law,[18] but the point was not ruled upon under the 1916 Law.

Foreign Governments. Any income collected by foreign governments from investments in the United States in

room therefor, delivering it to customers, purchasers thereof, soliciting contracts by agents for the purchase and supply of same, renting and paying rent for a room for doing the business, depositing and collecting the checks received in payment and paying the expense of the business therefrom, all done in the State of New York in the United States. It was not necessary that the contracts should have been made wholly in the United States, or that their execution or performance should have been wholly in the United States.'' Under the 1909 Law it was held that where the foreign corporation owned timberlands in this country and operated a match factory but sold its lands and plant, payments to be made in installments, the foreign company to retain the title until paid in full, it was not doing business, although retaining an attorney in the state to look after its interests and an agent for service of process as required by state statute. (Bryant and May, Limited, v. Scott, 226 Fed. 875.) Under the same state of facts the corporation would be taxable under the present law.

16 28 Op. Atty. Gen. 211; Aguirre v. Maxwell, 3 Blatch. 140; Peck v. Lowe, 247 U. S. 165.

17 Reg. 45, Art. 92.

18 T. D. 1675.

stocks, bonds, or other domestic securities, which are not actually owned by but are loaned to such foreign governments, is subject to tax. The income of foreign ambassadors and ministers from investments in bonds and stocks and from interest on bank balances, and the fees of foreign consuls, are exempt from tax. The compensation of citizens of the United States who are officers or employees of a foreign government is, however, not exempt from tax.[19] Under the 1916 Law, prior to the amendment of October 3, 1917, it was held by the Treasury Department that the income accruing to a foreign government from sources within the United States arising from interest on bonds or dividends on stock of domestic corporations was subject to tax. The 1917 Law provided that the income of foreign Governments received from investments in the United States in stocks, bonds, or other domestic securities owned by them, or from interest on deposits in banks in the United States of money belonging to such foreign Governments was exempt. This did not, however, exempt from the tax any income collected by foreign Governments from investments in the United States in stocks, bonds, or other domestic securities, which were not *bona fide* owned by but were loaned to such foreign Governments. The exemption was and still is predicated upon the fact that the securities or moneys from which income was derived were actually owned by such foreign Governments.[20]

Collection of the Tax at the Source. The withholding provisions applying to foreign corporations contained in the Revenue Act of 1918 are different from the provisions of the 1916 Law which are briefly set forth in the footnote below.[21] In the case of non-resident foreign corpora-

[19] Revenue Act of 1918, § 213 (b) (5); Reg. 45, Art. 81.

[20] Reg. 33 Rev., Art. 87; T. D. 2425; Revenue Act of 1916, as amended by Revenue Act of 1917, § 30.

[21] Under the 1916 Law, as amended, a normal tax was withheld at the source upon all interest on bonds and mortgages or deeds of trust or similar obligations of resident corporations, and upon all dividends upon the capital stock or from the net earnings of resident corporations. (Revenue Act of 1916, § 13 (c).) There is now

tions, as defined above, a tax equal to 10% is withheld at the source on payment of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits and income, except that the law requires a tax equal only to 2% to be withheld at the source on all interest on bonds, mortgages, or deeds of trust or other similar obligations of a corporation containing a so-called tax-free covenant.[22] A non-resident foreign corporation cannot by filing any certificate or claim for exemption prevent the withholding of such tax, but if there is included in the annual return, which such corporation is required to make of all income received from sources within the United States, any income upon which tax has been withheld at the source, the corporation may take credit against the amount of tax due for the amount of the tax so withheld at the source; provided a statement is attached to the return setting forth the source and the amount of the income upon which the tax was so withheld.[23] If a return discloses the fact that more tax has been withheld than is assessable against the corporation, the Treasury Department then orders a refund of the excess amount withheld. For this purpose the return of the foreign corporation

no withholding upon income received as dividends from a corporation, which is taxable upon its net income, but with this exception, withholding is required in the case of non-resident foreign corporations upon a more extended class of income, as indicated in the text above. See also Chapter 40 on Collection of the Tax at the Source.

22 Revenue Act of 1918, §§ 221, 237. The tax on corporation bonds containing "tax-free covenants" is required by law to be withheld only at the rate of 2% in order to limit the obligation of debtor corporations under those covenants. It seems, therefore, on such bonds the remainder of the income may be paid over without withholding by the debtor corporation. Some plan of collecting the remaining tax, amounting to 8% of the interest paid is no doubt being considered by the Treasury Department, but it is difficult to find a method by which this can be done without increasing the liability of the debtor corporations under their covenants, which liability the law expressly limits.

23 Reg. 33 Rev., Art. 201.

should have attached thereto a statement giving the names of the withholding agents and the amounts withheld respectively.[24] There is no collection of the tax at the source on payments of any kind to resident foreign corporations.[25]

INTEREST ON BANK DEPOSITS PAID TO NON-RESIDENT FOREIGN CORPORATIONS. Although interest on bank deposits paid to non-resident foreign corporations was subject to tax, under the 1916 Law, the Treasury Department did not require the withholding of any tax upon such interest.[26] But under the present law withholding will be required.

PROCEDURE IN COLLECTING INCOME SUBJECT TO WITHHOLDING. To enable debtors in the United States to distinguish between foreign corporations which have and those which have not any office or place of business in the United States, and also to enable such corporations as have an office or place of business in the United States to claim exemption from withholding the tax on bond interest or other income, a certificate stating that any such corporation has an office or place of business in the United States should be filed by it with the debtor.[26a]

Nominal Stockholders. Under the 1916 law where the stock of domestic corporations stood in the name of nominal stockholders and the actual owners were non-resident foreign corporations, that fact was required to be dis-

[24] Reg. 33 Rev., Art. 201. (See also Reg. 33 Rev., Art. 43, Reg. 33, Art. 46, and Chapter 40 on Collection of the Tax at the Source.)

[25] Reg. 45, Art. 362.

[26] T. D. 2652, revoking T. D. 2623. The Treasury Department differentiated between non-resident alien individuals and non-resident foreign corporations, who were recipients of such bank interest, requiring withholding in the case of the former but not in the case of the latter. (See also telegram from Treasury Department, dated February 13, 1918; I. T. S. 1918, ¶ 3082.) The reason for the distinction was that the law required withholding against foreign corporations only on interest from corporate bonds and obligations. (Revenue Act of 1917, § 13 (e).)

[26a] Reg. 45, Art. 601.

closed. In cases where such corporations were nominal stockholders, withholding of the tax might be avoided by disclosing the actual owners. As to duties of nominal stockholders under the present law see the chapter on that subject.[27]

Resident Agents for Foreign Corporations. In addition to the provisions prescribed by law for the collection of the tax at the source on income paid to non-resident foreign corporations the Treasury Department evolved under the 1916 Law a method of collecting the tax by impressing upon residents of this country under certain circumstances the duty of filing returns and accounting for all the taxes due from non-resident foreign corporations on the income which passed through their hands. The Revenue Act of 1918 contains no provision corresponding to the provision under which such duty was imposed, but the Treasury Department has ruled that the responsible representatives of non-resident aliens in connection with sources of income which such non-resident aliens may have within the United States shall make a return of such income and shall pay any and all tax normal and additional assessed upon the income received by them in behalf of their non-resident alien principals in all cases where the tax on income so in their receipt, custody or control shall not have been withheld at the source. Such agent is responsible for a correct return of income accruing to his principal within the purview of his agency, the agency appointment determining how completely the agent is substituted for the principal for tax purposes. A similar ruling will no doubt be made applying to non-resident foreign corporations.[28]

Income Subject to Tax. The gross income of a foreign corporation includes only the gross income from sources within the United States[29] including the items set forth

[27] See Chapter 7.

[28] Reg. 45, Art. 403. See Revenue Act of 1916, § 9 (g) and Chapter 6 on Resident Agents.

[29] Revenue Act of 1918, § 233, (b).

in the introductory paragraph of this chapter. From the amount of such gross income may be subtracted the sum of the deductions enumerated in the law, with the exceptions and subject to the limitations indicated in the introductory paragraph of this chapter.[30]

STEAMSHIP COMPANIES. It was held under the 1916 Law that where a foreign steamship company had steamers which touched American ports and which carried therefrom freight and passengers the return should show as gross income the total receipts from all out-going boats whether freight or passenger. With the gross income thus ascertained, the ratio existing between it and the gross income from all ports both within and without the United States was determined as the basis upon which deductions might be computed.[31]

FOREIGN CORPORATIONS HAVING BRANCH OFFICES IN THIS COUNTRY. Where a foreign corporation has one or more branches in this country and where such branches transact business in foreign jurisdictions, the net income accruing to the branch here, it seems that the income derived from such business in foreign jurisdictions should be treated as income from sources within this country, since the management and conduct of such business is directed from within this jurisdiction and the foreign corporation eventually receives its net income from a source within this country, namely, the branch conducting such business.

FOREIGN CORPORATIONS HAVING NO OFFICE OR AGENT IN THIS COUNTRY, COLLECTING COMMISSIONS. It was ruled under the 1916 Law that a foreign corporation, having no office or agent in this country, but selling in foreign countries certain products of manufacturing establishments in this country, the purchase price being transmitted by the purchasers direct to the American manufacturers, was not taxable on commissions paid out of

30 Revenue Act of 1918, § 234 (b). See Page 247.

31 Letter from Treasury Department dated July 18, 1916; I. T. S. 1918, ¶ 1161.

the proceeds of the sales, such commissions not being income from sources within the United States.[32]

INCOME FROM INVESTMENTS. Income from investments of all kinds in property located within this country is subject to the tax under the broad provisions of the law which provide for the taxation of the total net income from sources within the United States.[33]

Deductions from Gross Income Allowed by Law. It was required by regulations issued under the 1916 Law that the deductions from the gross income of a foreign corporation should as nearly as possible represent the actual expenses and authorized charges incident to the income derived from this country, and must not comprehend either directly or indirectly any expenditures or charges incurred in the transaction of business or the investment of capital without the United States.[34] The principle followed by the Treasury Department was that all allowable deductions should be computed upon a basis which recognized that the income arising and accruing from business done in and from this country should bear its share, and no more, of expense incident to the earning or creation of such income in the ratio that the gross income arising in and from this country bore to the en-

[32] Letter from Treasury Department dated April 20, 1918; I. T. S. 1918, ¶ 3324. See p. 67.

[33] Revenue Act of 1918, § 233 (b). Under the 1913 Law the tax was imposed only upon such foreign corporations as were doing business *and* had capital invested in this country. The Treasury Department construed this to mean that the tax applied if a foreign corporation was either doing business *or* had capital invested here and held that money invested in the securities of American corporations was capital invested in the United States regardless of the domicile of the securities or that of the corporation owning them. (Letter from Treasury Department dated June 6, 1916; I. T. S. 1918, ¶ 1682.) In De Ganay v. Lederer, 239 Fed. 568, it was held that the income tax properly applied to income on domestic securities owned by a non-resident alien, which securities were kept in this country. (This case is now No. 319 on the Docket of the United States Supreme Court.)

[34] Reg. 33 Rev., Art. 197; Reg. 33, Art. 157.

tire gross income arising from business done both within and without this country.[35] The Revenue Act of 1918 expressly provides that in the case of foreign corporations, the deductions allowed (with the exceptions of interest and certain taxes, which are discussed in later paragraphs in this chapter) "shall be allowed only if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary."[36]

WHEN INCOME IS DERIVED FROM INVESTMENTS ONLY. A corporation deriving its sole income from this country in the form of dividends or interest on domestic stocks and bonds was permitted under the 1916 Law to deduct from the income so received such items of disbursement, loss, etc., as would be properly deductible, if the income were derived from any other source. The deduction comprehended only such expenditures, losses, etc., as were incurred in or were incidental to the creation of the income against which they were charged, and in all cases the amounts were required to be within the limits fixed by the 1916 Law.[37]

ORDINARY AND NECESSARY EXPENSES. Foreign corporations may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation

[35] Letter from Treasury Department dated July 18, 1916; I. T. S. 1918, ¶ 1161.

[36] Revenue Act of 1918, § 234 (b).

[37] Letter from Treasury Department dated June 6, 1916, I. T. S. 1918, ¶ 1682.

has not taken or is not taking title or in which it has no equity. The deduction of such expenses, however, is subject to the conditions stated above.[38] Where under the 1916 and prior laws certain expenses, such as coal, ships, stores, etc., in the case of foreign steamship companies, could not be segregated, the total expenses of foreign corporations for such items were pro-rated in such proportion as the gross income of the corporation from sources within the United States bore to the gross income derived from all sources both within and without the United States; that is to say, if one-half of the gross income of the foreign corporation was from sources within this country, one-half of such expense was a proper deduction.[39] A Canadian manufacturing corporation which sells part of its product in the United States and part in Canada should report its deductions for cost of manufacture, exclusive of interest paid on its indebtedness, in the same proportion as the quantity of its product sold in the United States bears to the total quantity sold.[39a]

INTEREST. A foreign corporation may deduct that proportion of all interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from income tax to the foreign corporation, which the amount of the gross income of the foreign corporation from sources within the United States bears to the amount of its gross income from all sources within and without the United States.[40]

38 Rev. Act of 1918, § 234, (a) 1, (b).

39 T. D. 1675; Reg. 33, Art. 116; Letter from Treasury Department dated December 8, 1916. This chapter contains only rulings applicable to foreign corporations. Chapter 12 on Domestic Corporations and the chapters discussing the general provisions relating to deductions should be read as well, especially for any changes introduced by the Revenue Act of 1918.

39a Reg. 45, Art. 571.

40 Revenue Act of 1918, § 234 (a) 2 and (b). Foreign corporations

INTEREST PAID BY BANKS ON DEPOSITS. A foreign bank, banking association, loan or trust company, or branch thereof was permitted under the 1916 Law to deduct in full the interest paid within the year on deposits by or on moneys received for investment from either citizens or residents of the United States and secured by interest-bearing certificates of indebtedness issued by such bank, banking association, loan or trust company, or branch thereof.[41] Interest so paid to citizens and residents being taxable as income to them, seems to be properly deductible from the income of a foreign corporation, but the present law contemplates that all interest shall be apportioned as indicated in the preceding paragraph.

were permitted, under the 1916 Law, to deduct part of the interest paid during the year, under the following rules: The indebtedness of interest on which interest might be deducted could not be in excess of the entire amount of the paid-up capital stock outstanding at the close of the year, or in the absence of capital stock, the entire amount of the capital of the business employed at the close of the year, plus one-half of its interest-bearing indebtedness then outstanding; that is to say, the greatest amount of interest which a foreign corporation could deduct was limited in the same way as in the case of domestic corporations. If the foreign corporation did all its business in the United States, the interest on the amount of indebtedness ascertained as above might be deducted. If it did only a part of its business in the United States there might be deducted only the interest paid on such proportion of the amount of indebtedness ascertained as above as the gross amount of its income for the year from business transacted and capital invested within the United States bore to the gross amount of its income derived from all sources within and without the United States. Foreign corporations were not permitted to deduct the amount of interest on indebtedness incurred for the purchase of obligations or securities the interest upon which was exempt from income tax. The provision of Law (Revenue Act of 1916, § 12 (a)), permitting a deduction to domestic corporation of the full amount of interest paid on indebtedness secured by collateral, the subject of sale or hypothecation in the ordinary business of the corporation was held not to apply to foreign corporations. See p. 236.

41 See Reg. 33, Rev., Art. 190 as to the general ruling. No formal ruling was made with respect to foreign corporations but the statement in the text is based on the practice of the Department.

TAXES. A foreign corporation may deduct taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war profits and excess-profits taxes, or (b) by the authority of any possession of the United States, except income, war-profits and excess-profits taxes, or (c) by the authority of any State or Territory or any County, school district, municipality or other taxing subdivision of any state or territory or (d) by the authority of any foreign country (except income, war profits and excess-profits taxes, and taxes assessed against local benefits of a kind tending to increase the value of the property assessed). In the case of (a), (b), and (c) above, the deduction is allowed to foreign corporations without any limit, but in the case of (d), it is allowed only if and to the extent that the taxes are connected with income arising from a source within the United States.[42]

LOSSES. A foreign corporation may deduct all losses sustained during the taxable year and not compensated for by insurance or otherwise, to the extent that they are connected with income arising from a source within the United States.[43] But it does not seem that the business or property with respect to which the loss is sustained need be located in the United States.[44]

[42] Revenue Act of 1918, § 234 (a) 3, (b). Under the 1916 Law a foreign corporation might deduct taxes paid within the year imposed by the authority of the United States (except income and excess-profits taxes) or its territories or possessions or under the authority of any state, county, school district or municipality or other subdivision of any state, paid within the United States, not including those assessed against local benefits. This allowance for taxes was the same as that allowed to domestic corporations and to individuals except that it was expressly limited to cases where the tax was assessed by a governmental authority within the jurisdiction of the United States and the tax paid within the United States. (For a general discussion of the extent to which taxes may be deducted see Chapter 29 on Deduction of Taxes.)

[43] Revenue Act of 1918, § 234 (a) 4 and (b).

[44] Under the 1916 Law the losses which might be deducted were

LOSSES IN VALUE OF INVENTORY. The new provision of the Revenue Act of 1918 [45] relating to losses in the value of inventory and to a redetermination of the value of inventories taken at the close of the taxable year 1918 applies to foreign corporations as well as domestic corporations subject to the limitation that such losses must be connected with income arising from a source within the United States. This subject is more fully discussed in another chapter.[46]

NET LOSSES. The provision [47] of the Revenue Act of 1918 with regard to net losses applies to foreign corporations as well as to domestic corporations. The deduction of such losses is more fully discussed in another chapter.[48]

WORTHLESS DEBTS. A foreign corporation may deduct debts ascertained to be worthless and charged off within the taxable year, if and to the extent that they are connected with income arising from a source within the United States.[49]

DIVIDENDS ON STOCK OF OTHER CORPORATIONS. A foreign corporation may deduct all amounts received as dividends from a corporation taxable upon its net income.[50]

DEPRECIATION. A foreign corporation may deduct a reasonable allowance for the exhaustion, wear and tear of property used in its trade or business, including a reasonable allowance for obsolescence.[51] The manufacturing need

those sustained in a business conducted in the United States. Revenue Act of 1916, § 12 (b).

45 Revenue Act of 1918, § 234 (a) 14.

46 See Chapter 30 on Deduction of Losses.

47 Revenue Act of 1918, § 204.

48 See Chapter 30 on Deduction of Losses.

49 Revenue Act of 1918, § 234 (a) 5, (b).

50 Revenue Act of 1918, § 234 (a) 6, (b).

51 Id. § 234 (a) 7, (b). The 1916 Law allowed deduction for depreciation if the business or trade was conducted within the United States (Section 12 (a) Second Clause). The present law allows it if "connected with income arising from a source within the United States."

not be conducted in the United States in order to permit any such deduction so long as the income therefrom is taxable in the United States by reason of the sale of the product therein. This subject is more fully disclosed elsewhere in this book.[52]

AMORTIZATION. A foreign corporation may deduct a reasonable amount for amortization in the case of buildings, machinery, equipment or other facilities constructed, erected, installed or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the war with Germany, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the war with Germany, in the same manner as domestic corporations, subject to the general requirement that all deductions in the case of foreign corporations will be allowed only if and to the extent that they are connected with income arising from a source within the United States.[53] This deduction is more fully discussed elsewhere in this book.[54]

DEPLETION OF NATURAL RESOURCES. Foreign corporations are allowed to claim depletion with respect to mines or oil and gas wells or other natural deposits and timber to the extent that the income therefrom is held to arise from a source within the United States.[55]

DEDUCTIONS FROM INCOME OF FOREIGN INSURANCE COMPANIES. The special deductions allowed in the case of insurance companies, domestic and foreign, are treated in another chapter.[56]

ITEMS NOT DEDUCTIBLE. In computing the net income of foreign corporations no deduction is allowed for any amount paid out for new buildings or for permanent im-

52 See Chapter 31 on Depreciation.

53 Rev. Act of 1918, § 234 (a) 8.

54 See Chapter 31 on Depreciation.

55 Rev. Act of 1918, § 234 (a) 9, (b). See Chapter 32 on Depletion.

56 See Chapter 13 on Insurance Companies.

provements or betterments made to increase the value of any property or estate or in restoring property or making good the exhaustion thereof for which allowance is or has been made. Foreign corporations are also not permitted to deduct any amount paid in premiums on any life insurance policy covering the life of any officer or employee or of any person financially interested in the trade or business carried on by the corporation, when it is directly or indirectly a beneficiary under such policy.[57] This subject is more fully discussed in another chapter.

Credits. In addition to the above mentioned deductions foreign corporations are allowed the same credits as are allowed to domestic corporations, except the specific credit of $2,000 which is allowed only to domestic corporations.[58] These credits are more fully discussed in another chapter.[59]

Returns. Every foreign corporation receiving income from sources within this country is required to make a return stating specifically the items of its gross income and the deductions and credits to which it may be entitled.[60]

WHEN FILED. The return of a foreign corporation, like that of a domestic corporation or individual, is filed on or before the 15th day of March, or the 15th day of the third month following the close of the fiscal year of the corporation, accordingly as the corporation reports on the basis of the calendar or a fiscal year.[61]

WHERE FILED. The return of a foreign corporation should be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or if it has no principal

57 Revenue Act of 1918, §§ 235 and 215. See Page 435.

58 Revenue Act of 1918, § 236.

59 See Chapter 12 on Corporations.

60 Revenue Act of 1918, § 239. Reg. 45, Art. 625. Form 1120 is used.

61 Revenue Act of 1918, §§ 241 (a) and 227 (a).

place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.[62]

By Whom Filed. The responsibility for filing the return of a foreign corporation rests in some cases on the agent of the foreign corporation in the United States,[63] as indicated in another chapter.[64] When the return is filed by the officers of the foreign corporation, the agent of the corporation in this country is relieved of the responsibility. A foreign corporation having several branch offices in the United States States was required, under the 1916 Law, to designate one of such branches as the principal office and to designate the proper officer to make the required return.[65] Agents for foreign steamship companies may sign the required returns if so authorized by their companies. The subject of filing returns in the case of bankruptcy or dissolution is treated in another chapter.[66]

How Prepared. The return of a foreign corporation is prepared in the same manner as the return of a domestic corporation, except that the statements contained therein should relate to income from sources within this country and the deductions should be limited as above indicated.[67]

How Signed and Sworn to. In case the return of a foreign corporation is filed by the home office, it should be sworn to by the president, vice president or other principal officer and by the treasurer or assistant treasurer, and be verified in the same manner as is required in the case of domestic corporations.[68] In case the return is signed by the agent for the corporation resident in this country, the affidavit on the form should be changed to

[62] Revenue Act of 1918, § 241 (b).
[63] Revenue Act of 1918, § 239. Reg. 45, Art. 625.
[64] See Chapter 6.
[65] Reg. 33, Art. 83.
[66] See Chapter 12 on Corporations.
[67] See Page 221.
[68] Revenue Act of 1918, § 239. As to the general provisions respecting the oath or affirmation, see Chapter 34 on returns.

show that report is made by such agent, and covers all the income coming into his hands or all the income of the corporation from sources within the United States, as the case may be.

Consolidated Returns. The Revenue Act of 1918 contains a new provision requiring the filing of consolidated returns by affiliated corporations, but this provision does not apply to foreign corporations.[69]

Special Returns. Resident foreign corporations are required to make the same special returns for the purpose of information at the source as are required of domestic corporations.[70] Non-resident alien corporations are not required to make special returns by any express provision of the law, but may be called upon under general provisions of the law for information respecting their income from sources in this country.

Duty of Foreign Corporations in Paying Out Income. Where a resident foreign corporation pays out income to others subject to the tax, it is subject to all the duties and responsibilities imposed upon domestic corporations as to withholding the tax at the source or reporting the names of the persons to whom such income is paid.[71] Non-resident foreign corporations are under no duty in paying out income to others, whether or not such payees are citizens or residents of this country.

Collection of Foreign Items. Resident foreign corporations undertaking as a matter of business or for profit the collection of foreign items are required to obtain a license in the same manner as domestic corporations.[72]

Penalties. Foreign corporations or their officers or employees are subject in certain cases to penalties, both specific and *ad valorem,* for failing or refusing to make

69 See Chapter 12 on Corporations.

70 Revenue Act of 1918, §§ 254, 255 and 256.

71 Revenue Act of 1918, §§ 221, 237 and 256. For a further discussion of this subject see Chapter 40 on Collection of the Tax at the Source and Chapter 39 on Information at the Source.

72 Revenue Act of 1918, § 259. See Chapter 12 on Corporations.

returns, supply information, pay or collect any tax or for wilfully attempting in any manner to defeat or evade the income tax. Such penalties are more particularly discussed in another chapter.[73]

[73] See Chapter 36 on Penalties and Compromises.

CHAPTER 15

EXEMPT ORGANIZATIONS

The Revenue Act of 1918, with the exceptions noted below, exempts the same classes of corporations as the 1916 Law, and it is probable that most of the extant rulings under the 1916 and earlier laws will be continued in force and applied under the new law. Section 231 of the 1918 Law expressly exempts fourteen classes of organizations from taxation. The first eight of these classes were exempt under the 1913 Law; the next five classes were added by the 1916 Law. The 1918 Law discontinues the exemption granted by the 1916 Law to joint-stock land banks and adds an exemption in favor of personal-service corporations. Corporations exempt under the 1916 Law were also exempt to the same extent under the 1917 Law.[1] Exempt corporations under the 1913 Law were exempt from all provisions of the law,[2] and it was held that this included exemption from the duty of acting as withholding agent, but under the 1916 Law and the present law such corporations are required to withhold the tax at the source, and to report payments of income to others, in the same manner as is required of taxable corporations.[3] Exemptions are of two kinds, (1) conditional and (2) unconditional. When the exemption of a corporation is unconditional, and the col-

1 Reg. 33 Rev., Art. 68.

2 The 1913 Law provided that "nothing in this section" should apply to the corporations enumerated as exempt; the 1916 Law: "there shall not be taxed under this title any income received by" such exempt corporations; the 1918 Law: "the following organizations shall be exempt from taxation under this title."

3 T. D. 2693; T. D. 2407; Reg. 33 Rev., Art. 81.

lector is satisfied that it comes within the exempted class, he will eliminate it from his lists and relieve it from the necessity of making future returns. When the exemption of a corporation is conditional, in order to be relieved from liability under the law, it must file with the collector an affidavit setting forth its character and purpose, and showing that no part of any income which it receives inures to the benefit of any private stockholder or individual, and that its income is used exclusively for the promotion of the particular purposes for which it is organized. The exemptions granted to corporations of the first, second, third, fourth, thirteenth and fourteenth classes enumerated in later paragraphs are unconditional; corporations of the other classes enumerated are only conditionally exempt.[4]

Foreign Corporations. The provisions of Section 231 of the 1918 Law apply to foreign corporations as well as to domestic corporations, except in the case of building and loan associations and co-operative banks.[5] In case a foreign corporation desires to be held exempt from the law and doubt exists as to whether or not it comes within the class of organizations enumerated in Section 231, it will be required to file a copy of its charter and by-laws and an affidavit executed by its principal officer showing the disposition made of such income as it receives and stating specifically whether or not any of the income so received inures to the benefit of any individual stockholder. The question whether or not the organization will be held to be exempt is determined by the Treasury Department upon the facts so shown.[6]

Exemption Limited to Classes Specifically Enumerated. Any corporation, no matter how created or organized, or what the purpose of its organization may be, is taxable

[4] Reg. 33 Rev., Arts. 67 and 68.

[5] The provisions of Section 11 of the 1916 Law were so held. Letter from Treasury Department dated December 6, 1916; I. T. S., 1918, ¶ 1182.

[6] Letter from Treasury Department dated December 6, 1916; I. T. S. 1918, ¶ 1182.

unless it comes within the classes of organizations specifically enumerated as exempt. A corporation is not exempt simply and only because it is primarily not organized and operated for profit. If income within the meaning of the law arises and accrues to a corporation, such income will be subject to the tax unless the corporation is one of the exempt organizations expressly enumerated in Section 231. Thus, commercial men's associations, and like organizations are not exempt, as they are not expressly enumerated, although they may be corporations not organized for profit.[7]

Where Question as to Right of Exemption Exists. In order to establish exemption, and thus be relieved from the duty of filing returns of income and paying the tax, it is necessary that every organization claiming exemption, except personal-service corporations, file an affidavit with the collector of the district in which it is located, showing (1) the character and purpose of the organization; (2) the source from which all its income is derived; (3) what disposition is made of such income; and (4) whether or not any of it is credited to surplus or inures or may inure to the benefit of any private stockholder or individual.[8] To such affidavit should be attached a copy of the charter or articles of incorporation and by-laws of the organization. Upon receipt of the affidavit accompanied by the copies of the charter, or articles of incorporation and copy of the by-laws by the Collector, he will advise the organization whether or not it is exempt. If, however, the Collector is in doubt as to the taxable status of the organization, he will refer the affidavit and accompanying papers to the Commissioner for decision.[9]

[7] T. D. 2152. See Commercial Travelers etc. Ass'n v. Rodway, 235 Fed. 370. T. D. 2152 also held farmers' mutual fire insurance companies to be taxable, but the 1916 Law subsequently expressly exempted such organizations. The 1918 Law expressly exempts them.

[8] Reg. 33 Rev., Art. 78; Reg. 45, Art. 511.

[9] T. D. 2693.

Where there is any doubt as to the status of a corporation under the provisions of the law, and its exempt status has not been established by the Treasury Department, the annual return should be filed (in blank if desired) and an affidavit attached thereto setting out fully the same information. If the collector is in doubt, he will refer the statement and return to the Commissioner for decision and withhold listing for assessment until a decision is reached.[10]

Right of Exemption Must Be Proved on Request. Corporations enumerated as exempt are required, at the request of the Collector or Commissioner of Internal Revenue, to establish their right by showing the character and purpose of the organization, the manner of distributing the net income, if any, or that none of the net income inures to the benefit of any private stockholder or individual. In the absence of such a showing such organizations may at any time be required to make returns of annual net income or disclose their books of account to a revenue officer for examination in order that the status of the company may be determined.[11] Having once satisfied the collector as to its right to exemption, a corporation is not required to make any further showing in subsequent years unless the collector has reason to believe that the status of the organization has changed, or that its net income is inuring to the benefit of the stockholders or members.[12] Collectors keep a list of all exempt corporations to the end that they may occasionally inquire into their status and ascertain whether or not they are observing the conditions upon which their exemption is predicated.[13]

Labor, Agricultural and Horticultural Organizations (first class). The exemption of this class is unconditional. Although the language of the statute is very

10 Reg. 33 Rev., Art. 79. Letter from Treasury Department dated November 1, 1916; I. T. S. 1918, ¶ 1180.

11 Reg. 33, Art. 88.

12 Mimeograph letter to Collectors No. 1148; I. T. S., 1918, ¶ 1201. T. D. 2137.

13 Reg. 33 Rev., Art. 80; Reg. 45, Art. 511.

broad, the law undoubtedly means only such organizations as are not organized for profit, have no income inuring to the benefit of their members, and are educational or instructive in character, having for their purpose the betterment of the condition of their members, the improvement of the grade of their products, and the encouragement and promotion of the industries named to a higher degree of efficiency.[14] A corporation engaged in the business of raising stock or poultry, or growing grain, fruits, or other products of this character as a means of livelihood and for the purpose of gain, is an agricultural or horticultural organization only in the sense that its name indicates the kind of business in which it is engaged and, as such, is not exempt.[15] Agricultural corporations owning sugar plantations and disposing of the product thereof have been held by the Treasury Department to be organized for profit and not entitled to exemption as agricultural organizations under this provision.[16] County fairs or like organizations of a quasi-public character, not themselves engaged in agricultural or horticultural pursuits, and which, by means of awards, prizes or premiums, etc., are designed to encourage better production, and no part of whose income, derived from gate receipts, entry fees, donations, etc., inures to the benefit of any private stockholder or individual, but is used exclusively to meet the necessary expenses or upkeep and operation, are held to be exempt.[17] But societies or associations which have for their purpose the holding of annual or periodical race meets and from which profits inure, or may inure, to the benefit of the members or stockholders are not exempt.[18]

Mutual Savings Banks (second class). This class of organizations is unconditionally exempt. The mutual savings banks which are exempt are those not having a capital

14 Reg. 33 Rev., Art. 73.
15 Reg. 33 Rev., Art. 74.
16 T. D. 2090.
17 Reg. 33 Rev., Art. 73.
18 Reg. 45, Art. 512.

stock represented by shares. As to what constitutes a mutual purpose see the discussion in the note to the paragraph on building and loan associations below, and the note to mutual or co-operative organizations of a local character. A Massachusetts savings bank, otherwise exempt, which establishes an insurance department under the statutes of that State, does not thereby become subject to tax upon the income received by such department.[18a]

Fraternal Beneficiary Societies (third class). Fraternal beneficiary societies, orders or associations are exempt if (a) they operate under the lodge system, or if they are for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and (b) if they provide for the payment of life, sick, accident, or other benefits to the members of such society, order or association or their dependents. One important characteristic of this class of exempt corporations is that they must operate under the lodge system, or be for the exclusive benefit of a society operating under such system. Such a society or organization is considered to be one organized under a charter or dispensation, with properly appointed or elected officers, with an adopted ritual or ceremonial, holding meetings at stated intervals, and supported by fees, due or assessments.[19] Mutual protective associations, not operating under a lodge system are not exempt under this provision since they lack one of the characteristics of this class.[20]

Domestic Building and Loan Associations and Co-operative Banks[21] (fourth class). A building and loan association entitled to exemption is one organized pursuant to the laws of the United States or of some State or Territory thereof, which accumulates funds to be loaned

18a Reg. 45, Art. 513.

19 Reg. 33 Rev., Arts. 77 and 239; Reg. 45, Art. 514.

20 Commercial Travelers etc. Ass'n v. Rodway, 235 Fed. 370. This case contains an extended discussion on the distinction between a mutual association and a fraternal association.

21 Co-operative banks were included by the 1916 Law.

to its members and to be repaid in small periodical installments. The statute requires that the members of the association shall share in its profits on substantially the same footing. Subject to this requirement, it does not prevent exemption that the association issues prepaid stock entitled to a specified percentage of the profits. Where, however, the association issues paid-up stock, the holders of which are entitled to a fixed dividend and also to share in the profits with all the other holders of stock, it is not exempt.[21a] If a corporation by any other name is carrying on an exclusive building and loan business, before it is entitled to exemption it will be incumbent upon it to show to the satisfaction of the Commissioner of Internal Revenue that it is in fact a building and loan association.[22]

21a Reg. 45, Art. 515.

22 Reg. 33 Rev., Art. 70. The 1909 and 1913 Laws provided that ''domestic building and loan associations, organized and operated exclusively for the mutual benefit of their members'' should be exempt. The 1916 Law contains the following exemption: ''domestic building and loan associations and co-operative banks without capital stock organized and operated for mutual purposes and without profit.'' The present law contains the exemption: ''Domestic building and loan associations and co-operative banks without capital stock organized and operated for mutual purposes and without profit.'' Under the 1916 Law it was ruled that mutuality in operation and in the distribution of profits and benefits was essential to exemption; that in order to come within the exempted class such associations must not only be domestic, but they must be organized and operated exclusively for mutual purposes and without profit, that is, all profits and benefits provided for in the articles of association and by-laws must be ratably distributed among all the members, regardless of the kind of stock held, according to the amount of money they had on deposit; and that an associatoin issuing different classes of stock upon which different rates of interest or dividends were guaranteed or paid, was not in the exempt class. (Reg. 33, Art. 87.) Under the 1909 Law it was ruled that building and loan associations were not exempt if they loaned money to others than their members, thus doing a business similar to that engaged in by banks or trust companies; and that building and loan associations which received sums of money on deposit not in payment of stock, and on which the depositor received a fixed rate of interest, regardless of the earnings of the association, were conduct-

Co-operative banks must be without capital stock and must be organized and operated for mutual purposes and without profit in order to be exempt.

Cemetery Companies (fifth class). A cemetery company having a capital stock represented by shares, or which is operated for profit or for the benefit of others than its members, does not come within the exempted class. A cemetery company of which all lot owners are

ing a business similar to a banking business and were therefore subject to tax unless they fell within the class of co-operative banks. (T. D. 1655). Under the 1909 Law it was decided that a building and loan association was exempt although it issued both prepaid and installment stock, but that one issuing preferred stock was not exempt. (Pacific Bldg. & Loan Ass'n v. Hartson, 201 Fed. 1011.) In Herold v. Parkview Bldg. & Loan Ass'n, 203 Fed. 876, the association issued two varieties of stock, one known as prepaid stock on which the full par value of $200 per share was paid by the holder at the time of the issuance of the stock, and upon which the company paid to the holder out of the profits of the association the sum of 5% per annum in lieu of participation by said stockholder in the general profits of the association, and a second stock known as installment stock whereon the holder paid one dollar per share per month and to which was added the proportionate share of the profits of the association after deducting expenses until the aggregate of payments and profits equaled the sum of $200, when the said sum was paid to the holder and the shares retired. The prepaid stock could be cancelled by the corporation at any time upon thirty days' notice and payment of the value thereof together with interest at the rate of 5% from the date of last payment of interest, and each holder of such stock could likewise upon thirty days' notice tender his certificate and require payment from the association. The association borrowed no money from individuals whether members or nonmembers, loaned no money to persons other than members of the association, but borrowed according to its business demands from a local bank. The association was organized under the Act of April 8, 1903 (Public Laws, p. 457), of New Jersey. It was held that mutual benefit does not necessarily mean equal benefit; that a building and loan association is organized and operated for the mutual benefit of its members when they share in the profits on substantially the same footing; and that exact equality is probably not possible where part of the stock is prepaid and part is installment, but an approximate equality sufficiently close for all purposes is certainly not beyond the reach of calculation.

members, issuing preferred stock entitling the holder to a semi-annual dividend of 4 per cent., and whose articles of incorporation provide that the preferred stock shall be retired at par as soon as sufficient funds are realized from sales and that all funds realized in addition thereto shall be used by the company for the care and improvement of the cemetery property, is within the exemption.[23]

Religious, Charitable, Scientific and Educational Corporations (sixth class). The exemption applies only to a corporation or association. It does not include the case of a trust, under which the trustee is authorized to use the trust property for religious purposes. In order to be exempt the corporation or association must meet three tests: (a) it must be organized and operated for one or more of the specified purposes; (b) it must be organized and operated exclusively for such purposes; and (c) no part of its income must inure to the benefit of private stockholders or individuals. (1) Charitable corporations include an association for the relief of the families of clergymen, even though the latter make a contribution to the fund established for this purpose; or for furnishing the services of trained nurses to persons unable to pay for them; or for aiding the general body of litigants by improving the efficient administration of justice. Educational corporations are those whose sole purpose is the instruction of the public, even if it merely disseminates propaganda on a single question. Thus an association inculcating prohibition or protectionist principles is exempt. The same is true of an association to promote acquaintance with the Spanish language and literature, although it has incidental amusement features; of an association to increase knowledge of the civilization of another country; and of a Chautauqua association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community and whose amusement features are incidental to this purpose. So-

23 Reg. 45, Art. 516; Reg. 33 Rev., Art. 71.

cieties designed to encourage the performance of first class orchestral music are not exempt, the purpose being merely to provide a high grade of entertainment. Scientific corporations include an association for the scientific study of law, to the end of improvement in its administration. (2) Where a religious corporation owns a large quantity of farm land and works it, and also manufactures and sells clothing and other articles for profit, it is not operated exclusively for religious purposes and is not exempt, even though its property is held in common and its profits do not inure to the benefit of individual members of the society. (3) It does not prevent exemption that private individuals, for whose benefit a charity is organized, receive the income of the corporation or association. The statute refers to individuals having a personal and private interest in the activities of the corporation, such as stockholders. If, however, a corporation issues "voting shares," which entitle the holders upon the dissolution of the corporation to receive the proceeds of its property, including accumulated income, the right to exemption does not exist, even though the bylaws provide that the shareholders shall not receive any dividend or other return upon their shares.[24]

Business Associations (seventh class). Business leagues, chambers of commerce and boards of trade are conditionally exempt; that is, those not organized for profit and no part of the net income of which inures to the benefit of any private stockholder or individual are exempt. A business league is an association of persons having some common business interest, which limits its activities to work for such common interest and does not engage in a regular business of a kind ordinarily carried on for profit. Its work need not be similar to that of a chamber of commerce or board of trade. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not such a league,

24 Reg. 45, Art. 517; Reg. 33 Rev., Art. 67.

since its members have no common business interest, and it is not exempt, even though all of its income is devoted to the purpose stated. A clearing house association, not organized for profit, no part of the net income of which inures to any private stockholder or individual, is exempt provided its activities are limited to the exchange of checks and similar work for the common benefit of its members. An association of persons who are engaged in the business of carrying freight and passengers by boats propelled by steam, which is designed to promote the legitimate objects of such business, all of the income of which is derived from membership dues and is expended for office expenses and the salary of a secretary-treasurer, is exempt from tax. An incorporated cotton exchange, whose shares carry the right to dividends, is organized for profit and is not exempt.[25]

Civic Organizations (eighth class). Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare are exempt. This class is therefore only conditionally exempt.[26] A corporation having capital stock and possessing a charter which authorizes it to buy, improve and sell real estate is organized for profit within the meaning of the statute and is not exempt from tax as a civil league or organization, even though it no longer exercises such powers for profit and is operated exclusively for the promotion of social welfare.[26a]

Clubs (ninth class). Clubs are conditionally exempt. Clubs organized and operated exclusively for pleasure, recreation and other non-profitable purposes are exempt if no part of the net income inures to the benefit of any private stockholder or member.[27] This exemption will reach practically all social and recreation clubs which are supported by membership fees, dues and assessments. If a club, by reason of the comprehensive powers granted in its charter,

25 Reg. 45, Art. 518.
26 Reg. 33 Rev., Art. 67.
26a Reg. 45, Art. 519.
27 Reg. 33 Rev., Arts. 67 and 72. Such clubs were held to be

engages in traffic, in agriculture, or horticulture, in the sale of real estate, timber, etc., for profit, it will be held that such club is not organized and operated exclusively for pleasure, recreation, or social purposes. It thus becomes a business or commercial enterprise, and any profit realized from such activities is subject to the tax imposed by this title, and the club so operated must make returns of annual net income.[28] A club desiring to be registered as exempt should file with the Commissioner of Internal Revenue a copy of its charter or an affidavit of its principal officer setting forth the nature of its organization, the purpose for which it was organized, the source, if any, from which it derives income, and the disposition made of such income.[29] It should, in addition to the disposition of its income, particularly show any surplus, and whether or not such surplus will ever inure to the benefit of any private stockholder or individual.[30]

CLUB—ACCUMULATING CHRISTMAS FUND. An incorporated club, composed of the employees of a corporation, was organized for social purposes. The only source of income of the club was the initiation fee, and this was expended solely for entertainments. Certain members, called participating members, made contributions to a "Christmas Fund," which fund was invested by the executive committee of the club as it saw fit. Shortly before Christmas in each year the investments were liquidated and the net fund distributed to the participating members in proportion to their contributions. It was held that the club was organized and operated exclusively for pleasure, recreation and other non-profitable purposes and that no part of its net

exempt under the 1913 Law, although that law did not contain the express exemption which appears in the 1916 and 1918 Laws. (Letter from Treasury Department dated May 4, 1914; I. T. S. 1918, ¶ 1192.)

28 Reg. 33 Rev., Art. 72; Reg. 45, Art. 520.

29 T. D. 2090.

30 Letter from Treasury Department dated February 12, 1916; I. T. S. 1918, ¶ 1194.

income inured to the benefit of any private stockholder or member. The fact that the executive committee received specific dues from certain members, to be invested in various ways and thereby derived income did not take it out of the exempt class, since the funds so received were not the property of the club and were returned, together with the profit thereon, to the contributing members.[31]

Mutual or Co-operative Organizations of a Local Character (tenth class). Farmers' or other mutual hail, cyclone or fire insurance companies, mutual ditch or irrigation companies, mutual or co-operative telephone companies, and like organizations of a purely local character, the income of which consists solely of assessments, dues and fees collected from members for the sole purpose of meeting expenses incurred in pursuance of the purpose for which the company is organized, are specifically exempt. This exemption is conditional. It should be noted that the essential features of this class are as follows: (a) They must be mutual or co-operative; (b) they must be of a purely local character; (c) the income must be solely from assessments, dues and fees collected from members, and such assessments, dues and fees must be used for the sole purpose of meeting expenses,[32] incurred in pursuance of the purposes for which the companies are organized. It is necessary to exemption that the income of the company be derived solely from assessments, dues and fees collected from members. If income is received from other sources, the corporation is not exempt, even though its additional income is tax exempt. Income, however, from sources other than those specified does not prevent exemption where its receipt is a mere incident of the business of the company. Thus the receipt of interest upon a working bank balance, or of the proceeds of the sale of badges, office supplies or equipment, will not defeat the exemption. The same is true of the receipt of interest upon liberty bonds,

31 Letter from Treasury Department dated January 12, 1917.
32 Reg. 33 Rev., Arts. 69 and 239.

where they were purchased as a patriotic duty and were afterwards sold. Where, however, such bonds are bought as a permanent investment, the receipt of the interest destroys the exemption. The receipt of what is in substance an entrance fee, charged by a mutual fire insurance company as a condition of membership, does not render the company taxable, although this fee is called a "premium." But the issuance of policies for stipulated cash premiums prevents exemption. An exchange or association to insure the owners of automobiles against fire, theft, collision, public liability and property damage, is exempt, since it performs functions of the same character as a mutual fire insurance company, and is a "like organization" within the meaning of the statute. The exemption does not include a telephone clearing association, whose business is to apportion toll rates between independent telephone companies handling the same calls and whose income consists of compensation paid by such companies and receipts from the sale of form blanks.[38]

[38] Reg. 45, Art. 521. In connection with this class of exempt corporations the decision in the case of Niles v. Central etc. Ins. Co., 252 Fed. 564, is interesting. The case arose under the Act of Oct. 22, 1914 (38 Stat. 762, c. 331) imposing a stamp tax on insurance policies, and contained an exemption reading, "provided that purely co-operative or mutual fire insurance companies or associations carried on by the members thereof for the protection of their own property and not for profit, shall be exempted from the tax herein provided." A mutual fire insurance company was organized under the laws of Ohio, which required the company to (1) charge a cash premium payable at the time of delivery of policies, and (2) to maintain an unearned premium reserve of a definite percentage of the cash premiums on unexpired risks, and which permitted the company to (1) maintain a surplus in excess of the above reserve, as an additional security to policy holders, and (2) to earn interest on both the above reserve and surplus by investing them; the cash premium in excess of the amount estimated as sufficient for the protection and payment of losses at the expiration of each policy being returnable to the policy holder. The company was held to fall within the exemption above quoted, because its primary purpose was not to derive incidental profit from interest on its reserve and surplus, or to undertake investments on behalf of its members, but

Co-Operative Dairies. Under the 1913 Law, which did not contain the foregoing exemption, it was held that co-operative dairy associations, whether issuing capital stock or not, were not exempt as agricultural organizations. In the preparation of their returns such associations were permitted to deduct from gross income the amount actually paid to members and patrons for milk, but any amount retained at the end of the year over and above expenditures was taxable as income.[34] This would hold true under the foregoing exemption but co-operative dairy companies or associations not having capital stock and engaged in collecting milk and disposing of the same or the products thereof, and distributing the proceeds of the business, less necessary operating expenses, among their patrons, upon the basis of the quantity of butter fat in the milk furnished by such patrons, are held to be exempt from the tax imposed by this title.[35]

Associations for Marketing Produce (eleventh class). Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them, are exempt.[36] Co-operative associations, in order to come within this exemption, must establish to the satisfaction of the collector or Commissioner the fact that, for their own account, they

solely to protect more effectively the property of its members. The court said: "The distinction drawn in the act is between those mixed mutuals, which, though commonly called mutuals, are in fact also doing a non-mutual business for profit, and the strictly mutual companies; not between the mutuals which carry a reserve and surplus, and those which levy assessments only after each loss. A mere incidental profit earned by way of interest on its invested safety funds, or on its bank balances, does not change the purely mutual character of the company, or indicate that its business, though thus earning a profit, is 'carried on for profit.' "

34 T. D. 1996.

35 Reg. 33 Rev., Art. 76; Reg. 45, Art. 522.

36 Revenue Act of 1918, § 231.

have no net income, their business being to market the products of their members, and that the entire proceeds of such marketing, less necessary selling expenses, are turned back or paid to the members on the basis of the quantity of produce furnished by them—quality and grade being considered—as the purchase price of such produce. If in the course of their business such associations purchase for cash at a stipulated price articles or produce with a view to selling them for gain, it will be held that such associations are organized for profit and such associations will be required to make returns of annual net income and include therein, for the purpose of the tax, all income derived from such transactions. If amounts paid to members are based solely upon the quantity of produce furnished, such amounts may be deducted from the gross proceeds of sales, and the taxable net income will be the amount of earnings passed to surplus, or distributed or distributable among members on the basis of their stock holdings.[37] A farmers' association is not exempt from taxation where in accounting to farmers furnishing produce for the proceeds of sales it deducts more than the necessary selling expenses incurred. Cooperative associations which act as purchasing agents are not expressly exempt from tax and must make returns of income, but rebates made to purchasers, whether or not members of the association, in proportion to their purchases may be excluded from gross income in computing the net income subject to tax.[38]

Corporations Owned by Exempt Corporations (twelfth class). Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to organizations which are themselves exempt from the income tax are also exempt.[39]

[37] Reg. 33 Rev., Art. 75.

[38] Reg. 45, Art. 522; T. D. 2737.

[39] Such corporations were held to be taxable under the 1913 Law in the absence of express provision in that law for their exemption. T. D. 2137.

Federal Land Banks and National Farm-Loan Associations (thirteenth class). Such banks and associations as provided in Section 26 of the Act of July 17, 1916, entitled "An Act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States, and for other purposes," are unconditionally exempt.[40]

Personal-Service Corporations (fourteenth class). Since the stockholders of personal-service corporations are taxable in the same manner as the members of a partnership,[41] personal-service corporations as such are exempt from tax.[42]

Joint-Stock Land Banks. Such banks were unconditionally exempt under the 1916 Law, as amended, as to income derived from bonds or debentures of other joint-stock land banks or any federal land bank belonging to such joint-stock land bank. They were taxable, however, as to income from other sources and consequently it would seem were not exempt from the requirement of making a return of annual income, since the exemption from making returns applied only to corporations not subject to the tax. The present law does not include joint-stock land banks in the list of exempt organizations.[43]

Income Accruing to State or Local Governments. In addition to the fourteen exemptions noted above, income is not taxed if it is derived from any public utility or from the exercise of any essential governmental function accruing to any state, territory or the District of Columbia or any political subdivision of a state or territory. Income accruing to the government of the Philippine Islands

40 Reg. 45, Art. 74., Reg. 33 Rev., Art. 68.

41 Revenue Act of 1918, § 218 (e).

42 Revenue Act of 1918, § 231.

43 Compare Revenue Act of 1916, § 11, and Revenue Act of 1918, § 231.

or Porto Rico or the government of any political subdivision of those possessions is also exempt. Where a state, territory or the District of Columbia, or any political subdivision of a state or territory, has prior to September 8, 1916, entered into a contract with any person or corporation to acquire, construct, operate or maintain a public utility no tax is levied upon the income derived from the operation of such public utility so far as the payment thereof will impose a loss or burden upon such state, territory or district or political subdivision, but this provision is not intended to confer upon such person or corporation any financial gain or exemption or to relieve such person or corporation from tax on the part or portion of such income to which such person or corporation is entitled under such contract.[44]

Federal Reserve Banks. The income of Federal Reserve Banks is exempt from income tax[45] by express provision in the Federal Reserve Act.[46] The dividends on the stock of such banks are exempt from tax in the hands of member banks.[47] Dividends paid by member banks are treated like dividends of ordinary corporations and are not exempt from tax.[48]

44 Revenue Act of 1918, § 213 (b), 7.
45 Also from war-profits or excess-profits tax.
46 Federal Reserve Act, 38 Stat. 251, Ch. 6, § 7.
47 Reg. 45, Art. 75. Federal Reserve Bulletin, April 1, 1916.
48 Reg. 45, Art. 75. Reg. 33 Rev., Art. 86.

CHAPTER 16

INCOME—IN GENERAL

A discussion of the various conceptions of income would be interesting but is out of place in a work of this character. For all practical purposes it is sufficient to state that the income taxable under the present laws is defined in the statute.[1] One conception of income excludes gains or increment in the value of capital assets, but this conception was not that of Congress, since the tax is not only upon income conceived as a production of capital, but also upon gains and profits derived from sales or dealings in property, growing out of the ownership or use of or interest in such property, whether real or personal, or from gains or profits from any source whatever.[2] For the purpose of discussion in this and the following chapters, the general rules and principles applicable to income from all sources will first be described, and thereafter, the special rules applicable to income from (1) personal services, (2) business, trade or commerce, (3) farming, (4) sales or dealings in property, (5) rent, (6) interest, (7) dividends, (8) royalties, (9) miscellaneous sources. The special rules relating to income from partnerships and fiduciaries are treated in the chapters on those respective subjects.[3]

What Constitutes Income. Income may be defined as the gain derived from capital, from labor, or from both

1 Revenue Act of 1918, § 213.
2 Revenue Act of 1918, § 213 (a).
3 See Chapters 10 on Partnerships and 8 on Fiduciaries.

combined.[4] The meaning of the word is not to be found in its bare etymological derivation. Its meaning is rather to be gathered from the implicit assumptions of its use in common speech. Of course the term is not limited to earnings from economic capital, i. e. wealth industrially employed in permanent form.[5] The courts have uniformly construed the word "income" to include only the receipt of actual cash as opposed to contemplated revenue due but unpaid, unless a contrary purpose is manifest from the language of the statute. What was taxed by the 1909 Law was "net income received," not income, accruing or accrued, which had not been received and portions of which might never be received.[6] While the phrases "income received" and "income accrued" are frequently used in the same statute, the courts have not departed, unless it expressly appears otherwise, from a construction of the law in accord with an intention to reach the actual and not the potential income.[7] In the 1913 Law the two preceding phrases were employed. Doubtless it was the intention of Congress to employ terms of sufficient comprehension to reach the actual income by foreclosing any possible avenue of escape, but it can hardly be said that in so doing an intention prevailed to tax that which did not actually exist, except on paper, as income accrued during the taxing period. One cannot be said to receive an income of defined proportions until he balances receipts and deductions at the end of a stated period and ascertains, not what is due, but what has been actually received. The assets and liabilities may be measured by a different rule

[4] Stratton's Independence v. Howbert, 231 U. S. 399; Doyle v. Mitchell Brothers, 247 U. S. 179.

[5] U. S. v. Oregon-Washington etc. Co., 251 Fed. 211.

[6] Act of August 5, 1909, § 38 (36 Stats. 112). The language of the 1909 Law was held to indicate that the net income, which was the measure of taxation, meant what had actually been received and not that which, although due, had not been received, its payment for any reason having been deferred or postponed. (Mutual Benefit Life Ins. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918).

[7] U. S. v. Schillinger, 14 Blatch. 71, Fed. Cas., No. 16,228.

of accounting, but income as defined by the courts means, as said in one case,[8] "in the absence of any special law to the contrary, income must be taken to mean money, and not the expectation of receiving it or the right to receive it at a future time." In the 1916 Law the phrase "income received" was used with respect to both individuals and corporations.[9] Under the Revenue Act of 1918 with the exception of stock dividends[10] all items of gross income shall be reported in the year in which they are received by the taxpayer[11] unless in order clearly to reflect income such amounts are to be accounted for as of a different period.[12]

Actual Receipts. The Revenue Act of 1918 intends primarily to tax individuals and corporations upon income received, and not income which has arisen or accrued, but has not been received.[13] This basis of actual receipts is not exclusively prescribed; for the statute recognizes as income-determining factors other items, among which are inventories, accounts receivable, property exhaustion and accounts payable for expenses incurred. Net income is computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer unless no such method of accounting has been

8 Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201, T. D. 2451. This case is now No. 395 on the docket of the United States Supreme Court.

9 Revenue Act of 1916, §§ 1 (a) and 10 (a).

10 Judge Mayer held in a decision (U. S. Dist. Ct. So. Dist. of N. Y.) handed down January 23, 1919, following Towne v. Eisner, 245 U. S. 518, among other cases that stock dividends are essentially not income and cannot be taxed as such. This decision was rendered under the 1916 Law. (See Chapter 23 on Income from Dividends).

11 The term "taxpayer" as used in this chapter includes any person, trust or estate subject to income tax. The term "person" includes individuals, partnerships and corporations. The term "corporation" includes associations, joint-stock companies and insurance companies.

12 Revenue Act of 1918, § 213 (a); Reg. 45, Art. 23.

13 Revenue Act of 1918, §§ 213 (a) and 233 (a). This was also true under the 1916 Law (Revenue Act of 1916, §§ 1 and 10).

employed or the method employed does not clearly reflect the income in which case the computation is made on such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.[14] Thus, individuals and corporations may report their income upon the basis of accruals instead of actual receipts. This provision is more fully discussed in subsequent paragraphs of this chapter.[15] If a taxpayer does not keep his accounts on such basis, the tax must be computed on the basis of actual receipts. An early ruling of the Treasury Department, under the 1913 Law, holding that a person receiving fees or emoluments for professional services must include all actual receipts for services rendered in the year for which the return was made, together with all unpaid accounts, charges for services or contingent income due for that year, was discussed in a case[16] in which the court said: "No such construction of the Treasury Department can enlarge the scope of the statute so as to impose the tax upon unpaid charges for professional services rendered, which for aught anyone can tell may never be paid. The statute alone determines what is income to be taxed. It taxes only income derived from many specified sources, and one does not derive income by rendering services and charging for them." Accrued but unpaid interest on investments has been held not to be income.[17] Under the broader language of the 1909 Law it was held that income was taxable only to the extent that it was actually received during the year, and did not include items which had been earned, or become due, but had not been collected.[18] It was also held under that law that items of "non-ledger assets" shown in the annual report of a life insurance company, made in pursuance to a state statute as "uncollected and deferred premiums" and "interest due and accrued,"

14 Revenue Act of 1918, §§ 212 (b) and 232.

15 See page 320.

16 Edwards v. Keith, 231 Fed. 110.

17 Ins. Co. of North America v. McCoach, 218 Fed. 905.

18 Connecticut Mut. Life Ins. Co. v. Eaton, 218 Fed. 206.

but no part of which had been received, were not a part of the company's "income received during such year."[19]

Constructive Receipt of Income. The rule stated in the foregoing paragraphs that the law taxes income "received" and not that which has "arisen or accrued" is subject to the qualification that income may be constructively as well as actually received. Actual receipt is a reduction to possession. Constructive receipt occurs where income is credited or made available to recipients and is to be reported as income; as for instance in the case of a credit to the account of recipients of savings-bank interest.[20] A taxpayer is deemed to have received items of gross income which have been credited or made available to him without restriction. On the other hand, appreciation in the value of property is not even an accrual of income to the taxpayer prior to the realization of such appreciation through conversion of the property.[21]

Bookkeeping Entries. Real facts and not bookkeeping entries constitute income. Books of account are no more than evidential; they are neither indispensable nor conclusive.[22] This does not mean that the return of net income should not be made in accordance with the taxpayer's books, for ordinarily the books reflect the real or actual facts. It means, for instance, that the Government is not precluded from going behind the taxpayer's books and assessing the tax on the actual facts. As a general rule, the method of accounting employed by a taxpayer determines his income. In some instances the law places a further determining importance on bookkeeping entries, as in the case of depreciation and in the case of worthless debts.[23] The latter seems to be the only item of income

19 Connecticut General Life Ins. Co. v. Eaton, 218 Fed. 188.

20 Reg. 33 Rev., Art. 4.

21 Reg. 45, Art. 23.

22 Doyle v. Mitchell, 247 U. S. 179.

23 Under the 1916 Law this was true also of cases of losses which were required to be sustained and "charged off" in order to be deducted by corporations. (Revenue Act of 1916, § 12 (a).)

or deduction expressly required by the law to be evidenced by book *entries* in the case of individuals. No system of bookkeeping or accounting is prescribed for all taxpayers, but the business transacted by the taxpayer should be so recorded that he may make a return of his true income and that each and every item set forth in the return of income may be readily verified by an examination of the books of account.[24] The books of a corporation are assumed to reflect facts as to its earnings, etc., hence they will be taken as the best guide in determining the net income, and, except as the same may be modified by provisions of the law wherein certain deductions are limited, the net income disclosed by the books and verified by the annual balance sheet, or the annual report to stockholders, should be the same as that returned for taxation.[25] Where an individual or a corporation reports on the basis of its books, and not on the basis of actual receipts and disbursements, the books must be kept so as to clearly reflect income. This basis is more fully discussed in the latter part of this chapter.[26]

Book Value of Assets. Neither the Government nor the taxpayer is bound by valuations entered on the books of the taxpayer.[27] Where property is carried at nominal value on the books of the taxpayer, and the Government seeks to assess a tax on the basis of that value, the taxpayer may prove, by other evidence, the true value of such property.[28] A book value increase in the value of capital assets due to a re-appraisal of property is not income within

[24] Reg. 45, Art. 24; Reg. 33, Art. 182; T. D. 2161.

[25] Reg. 33, Art. 183.

[26] See page 320.

[27] Doyle v. Mitchell Brothers, 235 Fed. 686, affirmed 247 U. S. 179.

[28] U. S. v. Guggenheim Exploration Co., 238 Fed. 231. In this case the value at which the property was acquired, the declaration of the board of directors as to such value, at the time of acquisition, and statements in the annual reports, were held to overcome in weight the alleged admission against interest in placing the valuation of the property on the books at a nominal amount.

the meaning of the law.[29] A book entry reflecting only an enhanced value of assets during the year evidences an increase in the net worth of the corporation or individual for that year, an increase which, under adverse conditions, may disappear the next year. An increase in value thus evidenced is intangible, unstable and is not such income as the law contemplates shall be returned for the purpose of the tax.[30] Returnable and taxable income is that actually realized during the year, evidenced by the receipt of cash or its equivalent. Hence mere book entries of an appreciation in the value of capital assets will be disregarded.[31]

Inventory. Taxpayers engaged in manufacturing or mercantile business usually determine their net income by inventory, purchases during the year plus the stock on hand at the beginning of the year, being subtracted from sales during the year plus stock on hand at the close of the year, or vice versa, to ascertain the gain or loss. The Treasury Department's first recognition of this system required that in every case where the annual gain or loss was determined by inventory, the merchandise must be inventoried at cost price, as any loss in salable value would ultimately be reflected in the sales during the year when the goods were disposed of. This rule permitting inventories on the basis of cost only was later altered and new rules established for the purpose of income and excess profits returns, permitting inventories at cost or market value, whichever is lower.[32] Except where inventories are allowed at cost or market, gain or loss must in all cases be determined on the basis of cost or of value as of March 1,

[29] T. D. 2005, Baldwin Locomotive Works v. McCoach, 221 Fed. 59.

[30] Letter from Treasury Department dated August 14, 1914; I. T. S. 1917, ¶ 260. See Reg. 45, Art. 23.

[31] Reg. 45, Art. 23; Letter from Treasury Department dated August 14, 1914; I. T. S. 1917, ¶ 260.

[32] T. D. 2609. The Attorney-General has advised on the basis of Doyle v. Mitchell Brothers, 247 U. S. 179, that the methods of taking inventories authorized by T. D. 2609 are permissible. (T. D. 2744; T. D. 2649.)

1913.[33] In no cases should overhead charges be included in inventory.[34] It is provided by the Revenue Act of 1918 that whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income,[35] and gain or loss is determined in the case of property acquired on or after March 1, 1913, on the basis of the cost thereof or inventory value, if the inventory is made in accordance with the above provision.[36]

INVENTORIES OF MERCHANDISE. In order to reflect the net income correctly, inventories at the beginning and ending of each year are necessary in every case in which the production, purchase or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption or use in productive processes, together with all finished or partly finished goods. Title to the merchandise included in the inventory should be vested in the taxpayer and goods merely ordered for future delivery and for which no transfer of title has been effected should be excluded. The inventory should include merchandise sold but not shipped to the customer at the date of the inventory, together with any merchandise out upon consignment. It should also include merchandise purchased, although not actually received, to which title has passed to the purchaser. In this regard care should be exercised to take into the accounts all invoices or other charges in respect of merchandise properly included in

33 T. D. 2609.
34 See instructions on back of Form 1031 for 1916.
35 Revenue Act of 1918, § 203.
36 Revenue Act of 1918, § 202 (a) 2.

the inventory, but which is in transit or for other reasons has not been reduced to physical possession.[37]

INVENTORIES OF SECURITIES. A dealer in securities, who in his books of account regularly inventories unsold securities on hand either (a) at cost or (b) at cost or market whichever is lower, may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another be authorized by the Commissioner. For the purpose of this rule, a dealer in securities is a merchant of securities, whether an individual, partnership or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers, that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, and not in the course of an established business, and officers of corporations and members of partnerships, who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.[38]

VALUATION OF INVENTORIES. Inventories should be valued at (a) cost or (b) market whichever is lower. Whichever basis was adopted by a taxpayer in respect of the taxable year 1917 must be continued unless upon application to the Commissioner permission is granted to change. If basis (b) is used it must be applied to each item in the inventory and not to a part only. Inventories should be

[37] Reg. 45, Art. 24, 1581; T. D. 2609.
[38] Reg. 45, Art. 1585; T. D. 2609; T. D. 2649.

recorded in a legible manner and properly computed and summarized and should be preserved as a part of the accounting records of the taxpayer.[39]

INVENTORIES AT COST. Cost means: (1) In the case of merchandise purchased, the invoice price less trade or other discounts except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods. Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be the goods most recently purchased. (2) In the case of merchandise produced by the taxpayer, (a) the cost of raw materials and supplies entering into or consumed in connection with the product, (b) expenditures for direct labor, (c) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital whether by way of interest or profit. In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry.[40]

INVENTORIES AT MARKET. Market means the current bid price prevailing at the date of the inventory for the particular merchandise, and is applicable to goods purchased and on hand and to basic materials in goods in process of manufacture and in finished goods on hand, exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts at fixed prices entered into before the date of the inventory. Where no open market quotations are available the taxpayer must

[39] Reg. 45, Art. 1582.
[40] Reg. 45, Art. 1583.

use such evidence of a fair market price as may be available to him, such as specific transactions in reasonable volume entered into in good faith, or compensation paid for cancellation of contracts for purchase commitments. The burden of proof will rest upon the taxpayer in each case to satisfy the Commissioner of the correctness of the prices adopted. It is recognized that in the latter part of 1918, by reason among other things of governmental control not having been relinquished, conditions were abnormal and in many commodities there was no such scale of trading as to establish a free market. In such a case, when a market has been established during the succeeding year, a claim may be filed for a recomputation of the net income of the preceding taxable year and an ajustment of the income and war excess profits taxes.[41]

LOSS IN VALUE OF INVENTORY. Losses under this heading relate only to a redetermination of the value of inventories taken at the close of the taxable year 1918. Such redetermination of value may be made (a) before the date of filing a return for that year, in which case the claim should be filed with the return, or (b) if no such claim is filed with the return, a claim may be filed subsequently thereto with the collector. Each claim should state the name and address of the taxpayer and should contain a concise statement of the amount of the loss sustained and the basis upon which it has been computed, together with all pertinent facts necessary to enable the Commissioner to determine the allowability of the claim. Each claim should be supported by an affidavit, and after one claim has been allowed no further claim can be considered. To be allowed such inventory loss must be substantial in amount and represent either (a) a realization by sale of goods taken in the inventory or (b) a shrinkage in market price (and such shrinkage must show sound evidence of permanency) of goods taken in the inventory and unsold at the date of the claim. In determining whether a loss

41 Reg. 45, Art. 1584.

has been realized by the sale of goods taken in the inventory, all sales made subsequent to the date of the inventory will be deemed to have been made from the inventoried stock until such inventoried stock is exhausted. No claim will be allowed for any loss of anticipated profits. Claims may also be made for a deduction from income of the taxable year 1918 of the amounts of payments actually made after the close of such taxable year on account of rebates in pursuance of contracts entered into during such year upon sales made during such year. In any case where payment of the tax has not been made prior to the filing of the claim no such payment shall be required upon the income covered by such claim until the claim is decided, but in such case the taxpayer shall accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the Commissioner, conditioned for the payment of any part of such tax found to be due. If any part of such claim is disallowed, then the remainder of the tax due shall bear interest at the rate of one per cent. per month from the time the tax would have been due had no such claim been filed. The amount allowed by the Commissioner in respect of any such claim shall be deducted from the net income for the taxable year 1918, and the taxes shall be recomputed accordingly and the excess of tax due, if any, shall be credited or refunded to the taxpayer. In computing income for the taxable year 1919, the opening inventory must be properly adjusted by the taxpayer in respect of any claim allowed for the year 1918 under this article. Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be the goods most recently purchased.[42]

Income Received in Kind. When income is received in kind, that is, in produce, crops, or other property hav-

[42] Revenue Act of 1918. §§ 214 (a) 12 and 234 (a) 10. Reg. 45, Art. 261.

ing no definite market value, the tax is assessable in the year in which such income is reduced to money or a money equivalent.[43]

Exchange of Property for Property. When property is exchanged or bartered for other property, neither having a fixed or determinable money value, and the exchange is not made on the basis of money value, no taxable income arises from the transaction.[44] Thus, an exchange of one horse for another horse, does not create taxable gain to either party to the transaction though each may feel convinced he is the richer by the deal. If either party subsequently sells the horse received by him in the exchange, his profit will then be the difference between the selling price of that horse and the cost to him of the horse he first owned. Prior to the present law no provision has been made in the statute for taxing profit on the exchange of property. The 1918 Law provides that when property is exchanged for other property having a market value the property received in exchange is treated, for the purpose of determining gain or loss, as the equivalent of cash to the amount of its fair market value.[45] Under that provision it is held that gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (a) that is essentially different from the property disposed of and (b) that has a market value. In other words, both (a) a change in substance and not merely in form, and (b) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized. By way of illustration, if a man owning ten shares of listed stock exchanges his stock certificate for a voting trust certificate, no income is realized, because the conversion is merely in form; or if he exchanges his stock for stock in a small, closely held cor-

[43] T. D. 2153.

[44] U. S. v. Smith, Fed. Cas. No. 16,341.

[45] Revenue Act of 1918, § 202 (b).

poration, no income is realized if the new stock has no market value, although the conversion is more than formal; but if he exchanges his stock for a liberty bond, income may be realized, because the conversion is into independent property having a market value. The exchange of a so-called convertible bond for stock pursuant to such a privilege granted in the bond will produce income if the stock received in exchange has a fair market value in excess of the cost or fair market value as of March 1, 1913, of the bond.[46]

Income Received in the Equivalent of Cash. Items of income, as well as expenditures, need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation of net income, can be valued in terms of money.[47] The Revenue Act of 1918 expressly provides that stock dividends shall be considered income to the amount of the earnings or profits distributed and that amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gains or profits.[48] Salaries, wages or compensation for personal services of whatever kind "and in whatever form paid" are taxable income.[49] Any property having a market value is the equivalent of cash when received in exchange for other property.[50]

CHANGE OF INVESTMENTS. The amount of income derived in the case of an exchange of property, as of stock for a bond, is the excess of the fair market value at the time of exchange of the bond received in exchange over the original cost of the stock exchanged for it, or over the fair market price or value of such stock as of March 1, 1913, if acquired

46 Reg. 45, Art. 1563; Letter from Treasury Department dated August 3, 1917; I. T. S. 1918, ¶ 1308.

47 Reg. 45, Art. 22.

48 Revenue Act of 1918, § 201 (c). But as to taxability of stock dividends see P. 397.

49 Revenue Act of 1918, § 213 (a).

50 Revenue Act of 1918, § 202.

before that date. The amount of income derived from a subsequent sale of the bond for cash is the excess of the amount so received over the fair market value of such bond when acquired in exchange for the stock. On the other hand, if the property received in exchange is substantially the same property or has no market value, then no gain or loss is realized, but the new property is to be regarded as substituted for the old and upon a sale of the new property the amount of income derived is the excess of the amount so received over the cost or fair market value as of March 1, 1913, of the old.[51] If property is exchanged for two different kinds of property, such as bonds and stock, the bonds having a market value and the stock none, the value of the bonds is to be compared with the cost or fair market value as of March 1, 1913, as the case may be, of the original property. If the market value of the bonds is less than such cost or value, the difference represents the cost of the stock. If the market value of the bonds is greater than such cost or value, the difference is taxable income at the time of the exchange and whenever sold the entire proceeds of the stock will be taxable. If property is exchanged for two different kinds of property, such as bonds and stock, neither having a market value, the cost or fair market value as of March 1, 1913, of the original property should be apportioned, if possible, between the bonds and stock for the purpose of determining gain or loss on subsequent sales. If no fair apportionment is practicable, no profit on any subsequent sale of any part of the bonds or stock is realized until out of the proceeds of sale shall have been recovered the entire cost or fair market value as of March 1, 1913, of the original property.[52] Where a broker induces a customer to change his investments, on the basis of market prices at a certain time, the difference in prices being adjusted by cash payment, such a transaction is one in which each party is able to compute in money values his

51 Reg. 45, Art. 1564. See Revenue Act of 1918, § 202 (b).
52 Reg. 45, Art. 1565.

gain or loss. Thus, as an illustration, Jones may have purchased a bond for $900, and Smith may have purchased ten shares of stock for $850. The market for each investment having gone up ten points, Jones and Smith exchange investments, Smith paying $50 additional in cash. As a result, Jones is in possession of stock having a market value of $950 and $50 in cash, while Smith has a bond with a market value of $1,000, but his amount of cash is reduced by $50. Upon analysis it is seen that the transaction is in fact a double one equivalent to each party having paid the other in cash the full market value of the security, and having purchased from the other, for cash, a new security. Each has clearly realized a gain of $100 and, with respect to each, the transaction is a closed and completed one. Each should report income of $100 in his annual return.

STOCK RECEIVED IN EXCHANGE FOR SERVICES. Compensation paid an employee of a corporation in its stock is, if the stock has market value, to be treated as if the corporation sold the stock for its market value and paid the employee in cash.[53] Conversely, in an early ruling of the Treasury Department under the 1913 Law it was held that commission allowed salesmen paid in stock might be deducted as expense, if so charged on the books of the corporation, at the actual value of such stock.[54]

STOCK RECEIVED IN EXCHANGE FOR PROPERTY. When property is transferred to a corporation the stock received in exchange therefor is to be considered as the equivalent of cash if it has any market value. If it has no market value no tax will be imposed, but the stock should be carried on the books of the vendor of the property at the same value as that at which he formerly carried such property, in order that the gain or loss may be ascertained when he sells any of the stock. It may be that the Department will rule that a market price established for the stock at any time before the taxpayer files his return covering the period

53 Reg. 45, Art. 32.
54 Reg. 33, Art. 117.

in which the exchange takes place will fix a market value for the stock as at the time of exchange. In any event if no market price has been established during that time, the establishment of a market later would not seem to affect the taxability of the transaction.[55]

Reorganization, Merger and Consolidation of Corporations. When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss is deemed to occur from the exchange, and the new stock or securities are treated as taking the place of the stock, securities, or property exchanged. When in the case of any such reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock or securities exchanged, a like amount in par or face value of the new stock or securities received is treated as taking the value of the stock or securities exchanged, and the amount of the excess in par or face value is treated as a gain to the extent that *the fair market value* of the new stock or securities is greater than the cost (or if acquired prior to March 1, 1913, the fair market value as of that date) of the stock or securities exchanged.[56] Amounts distributed in the liquidation of a corporation are treated as

55 The Conference Committee struck out a provision of the Senate report on Revenue bill of 1918 designed to establish a definite rule. Under this provision when a person or persons owning property received in exchange for such property stock of a corporation formed to take over such property, no gain or loss was to be deemed to accrue from the exchange and the new stock or securities received were to be treated as taking the place of the stock, securities or property exchanged.

56 Revenue Act of 1918, § 202 (b).

payments in exchange for stock or shares, and any gain or profit realized thereby is taxed to the distributee as other gains or profits.[57] Prior to the enactment of these provisions, which are contained in the Revenue Act of 1918, the rulings upon this subject were obscure and inconsistent. It was held that in a case wherein a corporation acquired from stockholders the stock of another corporation, giving in exchange therefor its own stock, the transaction was one by which the corporation acquiring the stock became the sole stockholder of the other corporation; that as a result of this transaction no income accrued to the corporation whose stock was thus acquired. Neither would any income accrue to this corporation if later the holding corporation caused the assets of the underlying company to be transferred to it for mere nominal consideration.[58] It was held that if a corporation sold its capital assets in whole or in part and the purchase price was paid with stock issued by the purchasing company, the purchase price would be the actual value at the time of the stock issued in payment for such assets.[59] It was further held that if the shares of

[57] Revenue Act of 1918, § 201 (c).

[58] Reg. 33 Rev., Art. 124.

[59] Reg. 33 Rev., Art. 101. See also Letter from Treasury Department dated September 9, 1916; I. T. S. 1918, ¶ 1297. The original rulings of the Treasury Department were to the effect that upon a reorganization where a new corporation was formed with a larger par value, the transfer of the assets from the old to the new and the exchange of stock by the stockholders of the old for a greater par value of stock of the new, did not create taxable income. Letter from Treasury Department dated May 3, 1915; I. T. S. 1918, ¶ 1292; letter from Treasury Department dated April 1, 1915; I. T. S. 1918, ¶ 398. In the latter ruling it was said: "In this transaction there is nothing to indicate that the two shares of stock in the B. Company of a par value of $100 each, had a value in cash or its equivalent in excess of the value of the stock in the A Company. There is no evidence other than the difference in the quantitative par value of the shares of stock, that any gain, profit or income was realized from the exchange of the shares of stock. It is therefore the opinion of this office that no accounting of income will be required until such time as the individual in question sells the stock of the B Company at a

stock received by the selling corporation were distributed to its stockholders, the amount so distributed in excess of the stock (meaning apparently par value) held by them in the selling company would be considered income to the stockholders, to be returned as dividends.[60] In a later ruling it was held that if the purchase price was paid with stock issued by a purchasing company, the purchase price would be the actual value of the stock issued in payment for such assets,[61] and that if one corporation bought the assets of another and issued direct to the selling company its own capital stock in payment for the assets acquired, the transaction would be treated by the selling company as a sale of its assets, and the question as to whether profit or loss resulted from the sale would depend upon whether or not the value of the stock taken in payment for the assets was in excess of the fair market price or value as of March 1, 1913, of the assets sold or of their cost, accordingly as they were acquired by the selling company prior or subsequent to that date. If the value of the stock was so in excess, the amount of such excess would be taxable income for the year in which the assets were sold and were required to be so returned. If the excess over value as of March 1, 1913, or over cost, as the case might be, included any surplus earned since March 1, 1913, upon which the income tax had been paid, the excess or profits resulting from the sale might be reduced by the amount of such tax-paid surplus. If the purchasing corporation took over all the assets including accounts receivable, bills receivable, surplus, etc., of the selling corporation and assumed its liabilities, the amount so assumed would be considered a part of the purchase price, and to the extent that the entire purchase price exceeded the cost or value, as of March 1, 1913, as the case might be,

price in excess of the capital which he originally invested in the stock of the A Company."

60 Letter from Treasury Department dated September 9, 1916; I. T. S., 1918, ¶ 1297.

61 Reg. 33 Rev., Art. 101.

of the assets disposed, income would accrue to the selling company. In other rulings it was held as indicated below.

WHERE EXCHANGE IS PAR FOR PAR. It was held under the 1916 Law that where in the case of reorganization new stock was acquired by a stockholder in exchange for old stock and both were of the same par value no income arose at the time of exchange, but when the new stock was sold the gain was required to be based upon the cost of the old stock or its value on March 1, 1913.[62] Where upon reorganization of a company stock of the new company was issued in exchange for shares of the old, the new company taking over the property of the old, no income accrued if the exchange of stock was share for share of like par value even though the property of the first corporation had increased in value over a period of years since its stock was first issued. Where the stock of both corporations was of like par value and predicated upon exactly the same assets the transaction resulted in no gains, profits or income to either the first corporation or its stockholders. If the stock of the first company at the time of the transaction was worth "double par" the stock of the second company, being supported by identically the same assets, was presumably of the same value, and the exchange of the new stock for the old resulted in no income. It was simply an exchange of assets of like character and like value.[63] Where an exchange was made of stock of one corporation for bonds in another corporation, the par value of the stock being equal to the par value of the bonds, no taxable income was held to result from the transaction, the transaction being an exchange of assets of a different form but of equal value.[64] It will be noted that the Revenue Act of 1918 provides that when in connection with the reorganization,

62 Letter from Treasury Department dated March 8, 1917; I. T. S. 1918, ¶ 1302.

63 Letter from Treasury Department dated March 8, 1917; I. T. S. 1918, ¶ 1302.

64 Letter from Treasury Department dated August 3, 1917; I. T. S. 1918, ¶ 1308.

merger, or consolidation of a corporation, a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value no gain or loss shall be deemed to occur from the exchange and the new stock or securities received are to be treated as taking the place of the stock, securities or property exchanged.[65]

RULING UNDER PRESENT LAW. Under the present law it has been ruled as follows: In general, where two corporations unite their properties by either (a) the dissolution of corporation B and the sale of its assets to corporation A, or (b) the sale of its property by B to A and the dissolution of B, or (c) the sale of the stock of B to A and the dissolution of B, or (d) the merger of B into A, or (e) the consolidation of the corporations, no taxable income is received from the transaction by A or B or the stockholders of either, provided the sole consideration received by B and its stockholders in (a), (b), (c) and (d) is stock or securities of A, and by A and B and their stockholders in (e) is stock or securities of the consolidated corporation, in any case of no greater aggregate par or face value than the old stock and securities surrendered. For the purpose of ascertaining the gain derived or loss sustained from the subsequent sale of any stock of A or of the consolidated corporation so received, the original cost to the taxpayer or the fair market price or value as of March 1, 1913, of the stock of B or A in respect of which the new stock was issued, less any untaxed distribution made to the taxpayer by A out of the former capital or surplus of B, or by the consolidated corporation out of the former capital or surplus of A or B, is the basis for determining the amount of such gain or loss.[66]

WHERE THE EXCHANGE IS FOR A GREATER PAR VALUE. It was held under the 1916 Law that where the assets of one corporation were transferred to another, the stockholders of the first receiving in exchange for their stock a greater amount of stock, par value, in the new corporation, the par

65 Revenue Act of 1918, § 202 (b).
66 Reg. 45, Art. 1566.

value of the new stock was to be considered as the equivalent of cash and taxable to the extent that it exceeded the cost of the old. Where the stockholders of a corporation surrendered their stock for stock of less par value, they were permitted to claim a loss on the difference between the cost of the old and the par of the new.[67] In later rulings, however, it was held that, upon a reorganization, where a new corporation was formed with a stock of larger par value, the transfer of assets of the old to the new and the exchange of stock by the stockholders of the old for stock of a greater par value of the new, created income to the old corporation and its stockholders; but that in determining the amount of such income, or the "amount received" by the old corporation and the "amount distributed" to its stockholders, the par value of the stock of the new corporation would only be taken as the actual value, or an equivalent of cash, "in the absence of any proof to the contrary." In other words, although the transaction was still held to be a closed and completed one, the conclusive presumption, that the par value of the stock of the new corporation represented actual value and was the equivalent of cash, was reduced to a rebuttable persumption; and the value of such stock became a matter of proof, or question of fact.[68]

RULING UNDER PRESENT LAW. The Revenue Act of 1918 provides that when in the case of any such reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock or securities exchanged, a like amount in par or face value of the new stock or securities received is treated as taking the place of the stock or securities exchanged, and the amount of the excess

67 Letter from Treasury Department dated March 9, 1917; I. T. S. 1918, ¶ 3222.

68 Letter from Treasury Department dated November 10, 1917; I. T. S. 1918, ¶ 1309; Letter from Treasury Department dated December 8, 1917; I. T. S. 1918, ¶ 1313; Letter from Treasury Department dated March 19, 1918; I. T. S. 1918, ¶ 3222.

in par or face value is treated as a gain to the extent that the fair market value of the new stock or securities is greater than the cost (or if acquired prior to March 1, 1913, the fair market value as of that date) of the stock or securities exchanged.[69] Under this provision it is ruled as follows: If in the case of any reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock and securities exchanged, income will be realized from the transaction by the recipients of the new stock or securities to an amount limited by (a) the excess of the par or face value of the new stock or securities over the par or face value of the old and (b) the excess of the fair market value of the new stock or securities over the cost or fair market value as of March 1, 1913, of the old. In other words, the taxable profit will be (a) or (b), whichever is less. Upon a subsequent sale of the new stock or securities their cost to the taxpayer will be the cost or fair market value as of March 1, 1913, of the old stock and securities, plus the profit taxed on the exchange.[70]

WHERE THE NEW STOCK HAS A MARKET VALUE. Under the 1916 Law it was held that where a stockholder holding shares in a company receives upon reorganization the same number of shares of the new company, and an equal amount in bonds, the bonds having a ready market value of par, and the stock a value of 50% of par, the exchange constituted a closed and completed transaction, in that the old stock had been disposed of for a readily determinable value, namely, the par value of the bonds and half the par value of the stock. Hence the stockholder had realized on his original investment a profit of 50%, which was required to be returned as income for the year in which the transaction took place. In this particular case it was also held that if the stockholder later on sold the bonds at par, and retained the stock, no income would be realized, and none

69 Revenue Act of 1918, § 202 (b).
70 Reg. 45, Art. 1567.

would be realized until the stock retained had been sold or disposed of for a price or value greater than 50% of its par, which amount was returnable as income under the first transaction.[71] The Revenue Act of 1918 provides as follows: When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any.[72] The rulings under the present law are discussed above.

WHERE THE NEW STOCK HAS NO MARKET VALUE. Under the former law the Department indicated that the gain or loss on exchange of property for stock would be determined by taking the "actual" value of the new stock as the selling price. The present law contemplates that gain or loss shall be determined by taking the "fair market value, if any" of the property received. If such property has no market value, the law does not contemplate that resort shall be had to any estimate of actual or intrinsic or market value. The law contemplates that a market shall exist, and it would seem to follow that such market should be wide enough to warrant the conclusion that all the stock received in exchange could be sold at the market price.

Payment in Notes. Deferred payment sales of real estate are sometimes not made on what is commonly known as the installment plan, but on a plan in which there is a substantial initial payment (ordinarily not less than one-fourth of the purchase price), deferred payments being secured by a mortgage or other lien. Such sales are distinguished from sales on the installment plan by the substantial character of the initial payment and also usually

71 Letter from Treasury Department dated August 3, 1917; I. T. S. 1918, ¶ 1308.

72 Revenue Act of 1918, § 202 (b). It was said in the district court in Sargent Land Co. v. Von Baumbach, 207 Fed. 423, affirmed 219 Fed. 31, reversed 242 U. S. 503, "The mere change of form of ownership from that of these individuals to that of a corporation owned by the same individuals cannot produce such large profits as are claimed here."

by a relatively small number of deferred payments. In the case of such sales, the obligations assumed by the buyer are much better secured than the obligations assumed by the buyer in the case of installment transactions because of the margin afforded by a substantial first payment, and experience shows that the greater number of such sales are eventually carried out according to their terms. These obligations for deferred payments are therefore to be regarded as equivalent to cash, and the profit indicated by the entire consideration is taxable income for the year in which the initial payment was made and the obligations assumed. If the buyer defaults and the seller regains title to the land by agreement or process of law, retaining payments previously made, he may deduct from his gross income as a loss such proportion of the defaulted payments as was previously returned as income, provided that so much of the selling price previously received as has not been reported as income is accounted for in the inventory of the property by deduction from the original cost.[73] A promissory note in settlement of an action, or in payment of an indebtedness or of interest, is considered to be the equivalent of cash and so much of such note as represents net income is subject to tax as of the year in which the note is received.[74] In one case under the Civil War Income Tax Laws it was held that promissory notes taken in payment of a patent right were not income until the note became due. The Court said: "In this case, the defendant changes his patent rights for promissory notes payable in the future. Their value was uncertain; they might or might not be paid; but, until they were paid, they were not income, but only the ground of expecting income. The notes were no more taxable as income than would have been other patent rights, if the defendant had received them in payment of those he sold."[75] In another

[73] Reg. 45, Arts. 41 and 43; T. D. 2137; T. D. 2090.

[74] Letter from Treasury Department dated March 1, 1915; I. T. S. 1918, ¶ 365.

[75] U. S. v. Schillinger, 14 Blatch. 71, Fed. Cas. No. 16,228.

case it was held that a transfer of stocks for a promissory note, which is collectible, or an exchange thereof for land, followed by a sale of such land within the year, for collectible promissory notes, is to be considered a sale of such stock for so much cash.[76]

Payment by Warrants. Where warrants are issued by a city, town, or other political subdivision of a State, and are accepted by the contractor in payment for public work done, the face value of such warrants must be returned as income for the year in which they are received. If, for any reason, the contractor upon conversion of the warrants into cash, does not receive and cannot recover the full face value of the warrants so returned, he may deduct from gross income for the year in which the warrants are converted into cash, any loss sustained, which loss will be measured by the difference between the face value of the warrants returned as income and the amount actually received for them in cash, or its equivalent, when redeemed or disposed of.[77]

Living Quarters, Board or Lodging. In cases where salary, rent, or other income is received in some form other than cash, the cash value of such consideration, it is held, should be computed and returned as income. The case of stock received in exchange for services has been discussed in a previous paragraph.[78] Thus where living quarters are furnished in addition to cash salary, the rental value of such living quarters should be reported as salary,[79] and where board, lodging, or other consideration is received in lieu of cash, the value thereof should be included as rent or salary, as the case may be.[80] Where service is rendered for stipulated price, wage, or salary and paid with something other than money, the stipulated value of service in terms of money is the value at which

[76] U. S. v. Smith, Fed. Cas. No. 16,341.
[77] Reg. 45, Art. 34; Reg. 33 Rev., Art. 108.
[78] See Page 302.
[79] T. D. 2090; Reg. 33 Rev., Art. 34.
[80] T. D. 2135.

the thing taken in payment is to be considered for the purposes of the income tax. Where there is no stipulation as to the value of service, and payment for service is made with something other than money, the market or reasonable value of the thing taken in payment is the amount to be included as income.[81] The law expressly provides that salaries, wages, or compensation for personal services shall be taxable "in whatever form paid," but does not so provide with respect to rent.[82] These rulings would be applicable to any payment required by contract to be made in some form other than cash, but it does not necessarily mean that because an employee occupies, rent free, a house owned by the employer, he must return the rental value as income. If it was not stipulated in the contract of employment that such living quarters should be furnished as a part of the salary or wages, the privilege of occupying the house is in the nature of a gift and no taxable income arises. Similarly where an employee uses his employer's property, horses, automobile, etc., by permission, and not by legal right, as a part of his compensation for services, no income arises to him on the ground that he is receiving value for which he would otherwise have to pay. If a person receives a fixed allowance to cover traveling or other expenses and expends less than the sum received, the excess should be treated as income.[83]

Income Taxable in Year Received. The time as of which any item of income is to be accounted for is to be determined in the light of the fundamental rule that the computation of net income shall clearly reflect the taxpayer's income.[84] Unless the taxpayer keeps his books on a basis other than that of actual receipts, and reports accordingly, he should report as income all amounts received in the year in which payment is actually made.[85] Thus

81 Reg. 33 Rev., Art. 4.
82 Revenue Act of 1918, § 213 (a).
83 T. D. 2079.
84 Reg. 45, Art. 22.
85 Reg. 45, Art. 23.

dividends and interest, professional fees of lawyers, physicians, and the like [86] need not be returned as income in the year in which they become due or are earned, but should be returned as income in the year in which the payments are received. In the case of compensation for services rendered, where no determination of compensation is had until the completion of the service, the amount received in consideration of the service is income to be accounted for as for the calendar year of its receipt, but if the amount is determined and placed to the credit of the taxpayer so that he could have drawn it, the amount is income for the year so credited and not for the year in which it is actually drawn.[87] Where the service and payment period is divided by the end of the taxable year, the compensation for the period so divided at the end of the year will be accounted for as income for the year in which payment is actually received. Where the service is compensated by fee, or is of such nature that no part of the fee or compensation becomes due until the completion of the service, the entire amount received should be income to be accounted for as for the year of receipt. A person having a salary by the year and in addition commissions on sales, the salary to be paid at the time commissions are determined, and the determination of commissions is in the succeeding calendar year, the entire amount of salary and commission should be accounted for as income of the calendar year of receipt.[88] It is immaterial that the services for which payment may be made have been performed for a period extending over several years, the entire payment is taxable in the year in which received, and may not be pro-rated.[89] In one case it was argued on behalf of an agent of a foreign insurance company, under a contract by the terms of which he should

[86] Letters from Treasury Department dated February 18, 1915, and March 1, 1915; I. T. S. 1918; ¶¶ 313 and 314.

[87] See "Constructive Receipt," Page 291.

[88] Reg. 33 Rev., Art. 4.

[89] T. D. 2135.

receive compensation on premiums of policies to the extent of certain specified percentages for a term aggregating twenty years from the date of each policy, that all of the labor creating such income had been performed prior to the incidence of the tax, but the court held that fact to be immaterial and sustained an assessment on the entire income for the year in which it was received.[90] The latest regulations[91] indicate that some of the foregoing rulings may be modified under the present law and that the general principle to be followed will be that gross income and deductions should be reported for the years in which they most appropriately belong, special consideration being given to unusual situations without adhering to inflexible rules.[92]

Receipt by Agent Is Receipt by Principal. A system of accounting adopted by an insurance company, which allowed a period of two months to local agencies in which to report their cash premium receipts to the home office, was held, in view of the rules and regulations of the Commissioner of Internal Revenue, not to "clearly reflect" the company's income. A payment to the agent was held to be payment to the principal, and the company was required to include such payments in the return for the year in which they were received by the agent. The provision of the 1916 Law, permitting a corporation to report according to its books, was held not to justify the system followed by the corporation in this case, as the system adopted must be such as to "clearly reflect its income,"[93] and the provision[94] of the Revenue Act of 1918 that if the method of accounting regularly employed does not clearly reflect the income, the computation of net income shall be made upon such basis and in such manner as in the opinion of the Commissioner of Internal Revenue

90 Edwards v. Keith, 231 Fed. 110.
91 Regulations 45.
92 Revenue Act of 1918, § 203.
93 See particularly Reg. 45, Art. 22.
94 Revenue Act of 1918, § 212 (b).

does clearly reflect income would seem to justify the same conclusion in respect to the present law.

Income from Foreign Countries. Where income has accrued in a foreign country on foreign investments but has not been remitted to the owner here, being placed to his credit in the foreign country, he should include the same as income for the year in which it is placed to his credit, computing the amount in United States money by using the rates of exchange prevailing at the time the amounts were credited abroad.[95]

Income Received from Porto Rico or the Philippines. In Porto Rico and the Philippine Islands the income tax is levied, assessed, collected and paid in accordance with the provisions of the Revenue Act of 1916. Returns are made and taxes paid in Porto Rico or the Philippine Islands, as the case may be, by (1) every individual who is a citizen or resident of Porto Rico or the Philippine Islands or derives income from sources therein, and (2) every corporation created or organized in Porto Rico or the Philippine Islands or deriving income from sources therein. An individual who is neither a citizen nor a resident of Porto Rico or the Philippine Islands, but derives income from sources therein, is taxed in Porto Rico or the Philippine Islands as a non-resident alien, and a corporation created or organized outside Porto Rico or the Philippine Islands, and deriving income from sources therein, is taxed in Porto Rico or the Philippine Islands as a foreign corporation.[96] Income received from Porto

[95] Letter from Treasury Department dated January 11, 1916; I. T. S. ¶¶ 358 and 1257.

[96] Revenue Act of 1918, § 261. A corporation or individual whose return under the 1916 Law is specifically required to be filed with the collector of one of the districts of the continental United States was not taxable in Porto Rico or the Philippines, although a portion of the income received might be derived from business carried on in one or both of those jurisdictions. Although the law provided that income collected in those jurisdictions "shall accrue intact to the general governments thereof," this was held to refer only to the tax legally assessable therein, and not to alter the general rule that

Rico or the Philippine Islands, or any other possession, must also be included in the return of a citizen or resident or a domestic corporation of the United States for purpose of tax under the 1918 Law, but the tax paid in Porto Rico or the Philippine Islands may be deducted from the tax due the United States under the rules relating to credit for taxes.

Gross Income. Prior to the enactment of the Revenue Act of 1918 the Treasury regulations and rulings referred to "gross income" generally as the income of the taxpayer before making the deductions and allowances permitted by law. The 1916 Law does not use the phrase "gross income," but in prescribing the deductions allowed to corporations made use of the phrase "gross amount" of its income. The Revenue Act of 1918 uses the term "gross income" for the first time, defining what is and what is not included therein, the latter being exempt income.[97] Gross income, in addition to excluding the items of income specifically exempted by the statute, also excludes certain other kinds of income by the statute or fundamental law free from tax.[98] Since exempt income is not included in gross income, obviously gross income is not synonymous with gross receipts.

Net Income. The phrase "net income" is defined by the Revenue Act of 1918 to be gross income as defined by the law less the statutory deductions.[99] Net income, as so defined, is only taxable for purposes of the surtax,[100] and for the purpose of the normal tax certain credits other than deductions are allowed in computing taxable net income, one of such credits being, in the case of individuals, the personal exemption and the others income not sub-

all of the tax should be paid in the district in which the taxpayer resided or had his or its principal place of business.

97 Revenue Act of 1918, §§ 213 and 235.

98 Reg. 45, Arts. 71, 21.

99 Revenue Act of 1918, §§ 212 (a) and 232 (a); Reg. 45, Art. 21.

100 Revenue Act of 1918, § 211 (a).

ject to normal tax.[101] Corporations also are entitled to certain credits in computing taxable net income.[102] Thus, taxable net income is wholly a statutory conception, although it follows, subject to certain modifications as to exemptions and as to some of the deductions, the lines of commercial usage. Statutory net income is, subject to these modifications, commercial "net income." This appears from the fact that ordinarily it is to be computed in accordance with the method regularly employed in keeping the books of a taxpayer.[103]

Exempt Income. In addition to income fundamentally free from taxation, the 1918 Law specifically prescribes the income which is not to be included in gross income and is exempt from tax. The intent seems to be that the income shall be exempt (with four exceptions) regardless of the status or character of the recipient.[104] The four exceptions are (a) the proceeds of life insurance pol-

101 Revenue Act of 1918, § 216 (a). Under the 1916 Law in the case of individuals the net income included the amount received as dividends and the amount of the personal exemption, that is, these amounts were not subtracted from gross income in arriving at what was termed net income but they were subtracted from net income only in arriving at the net taxable income for the purpose of the normal tax. Dividends are now a deduction in the case of corporations. (Revenue Act of 1918, § 234 (a) 6.)

102 Revenue Act of 1918, § 236.

103 Reg. 45, Art. 21.

104 Revenue Act of 1918, §§ 213 (a) and 233 (a). Under the 1916 Law there were four exceptions such as are enumerated in the text but three of them were entirely different from the present exceptions. The four exceptions were (a) proceeds of life insurance policies paid to individual beneficiaries upon the death of the insured; (b) compensation of the President of the United States; (c) compensation of the Federal Judges, and (d) compensation of officers and employees of a state or political subdivision thereof (Revenue Act of 1916, § 4). In the case of the last named class it is held by the Treasury Department that "officers or employees" refers only to individuals. The income specified in (b), (c) and (d) seems now to be subject to tax, subject to the determination of the courts as to the constitutionality of an income tax upon such income. But the income specified in (d) has been held not to be taxable. (See Chapter 17 on Income from Personal Services.)

icies paid upon the death of the insured to individual beneficiaries or to the estate of the insured (but not to corporations); (b) The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States, (c) income derived from any public utility, or the exercise of any essential governmental function and accruing to any state, territory, or the District of Columbia, or any political subdivision of a state or territory or income accruing to the government of any possession of the United States, or any political subdivision thereof and (d) so much of the amount received during the present war by a person in the military or naval forces of the United States as salary or compensation in any form from the United States for active services in such forces as does not exceed $3,500. The other provisions as to exempt income have no limitation with respect to the character or status of the recipient and the income would seem to be exempt whether received by an individual, a partnership or a corporation. Such income is as follows: (a) the amount received by the insured as a return of premiums paid by him or it under life insurance, endowment or annuity contracts (b) property acquired by gift, bequest, devise or descent (but the income from such property is taxable), (c) interest upon: (1) the obligations of a state, territory, or any political subdivision thereof, possessions of the United States, or the District of Columbia, (2) securities issued under the provisions of the Federal Farm Loan Act (3) the obligations of the United States, issued prior to September 1, 1917, and if issued after such date, if and to the extent the acts authorizing the issue thereof, or acts supplementary thereto, exempt the interest from taxation to the taxpayer, both under the income and the war-profits and excess-profits tax, (4) bonds issued by the War Finance Corporation if and to the extent stated

in (3) above; (e) amounts received through accident or health insurance, or under Workmens' Compensation acts as compensation for personal injuries or sickness and the amount of any damages received, whether by suit or agreement on account of such injuries or sickness (f) income of any person derived from the operation of a public utility to be acquired, constructed, operated or maintained by such person, pursuant to a contract made with the state, territory or the District of Columbia, or any political subdivision of a state or territory prior to September 8, 1916, in excess of the part thereof to which such person is entitled under such contract.[105] Since June 25, 1918, no assessment of any federal tax may be made on any allotments, family allowances, compensation or death or disability insurance payable under the War Risk Insurance Act of September 2, 1914, as amended, even though the benefit accrued before that date.[106] A more complete discussion of exemptions of income is contained in the several chapters dealing with the respective kinds of income enumerated.

Reporting Income on Basis of Book Entries. The 1916 Law extended to individuals or corporations keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis did not clearly reflect his or its income, the privilege of making returns upon the basis upon which the accounts were kept, in which case the tax was computed upon the income as so returned. This privilege was subject, however, to regulations made by the Commissioner, which regulations might limit the right as the Commissioner saw fit.[107] Taxpayers not keeping books in accordance with standard systems of

[105] Revenue Act of 1918, §§ 213 and 233. Every person owning obligations, securities or bonds the interest upon which is exempt must submit a statement in his return showing the amount of such obligations, securities and bonds owned by him and the income received therefrom.

[106] Reg. 45, Art. 71.

[107] Revenue Act of 1916, § 8 (g) and 13 (d).

accounting were required to report their income on the basis of actual receipts and payments, but where books were kept in accordance with standard systems of accounting, or in conformity with the requirements of some federal, state or municipal authority having supervision over the taxpayer, returns might be made on the basis upon which such books were kept, provided the books were so kept and the return so made as to reflect the true net income of the corporation for each year.[108] The Revenue Act of 1918 changes the privilege of reporting income upon the basis of book entries to a requirement that income be so reported. It is expressly provided that net income shall be computed in accordance with the method of accounting regularly employed in keeping the books of a taxpayer; if no such method of accounting has been so employed or if the method of accounting does not clearly reflect income the computation is to be made upon such basis and in such manner as in the opinion of the Commissioner of Internal Revenue does clearly reflect income.[109] Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. The method of accounting will not, however, be regarded as clearly reflecting income, unless all items of gross income and all deductions are treated with reasonable consistency. The two systems cannot overlap; a taxpayer may not report in part on the accrual and in part on the cash basis.[110]

METHODS OF ACCOUNTING. It is recognized that no uniform method of accounting can be prescribed for all tax-

108 T. D. 2433. In this ruling the Treasury Department placed certain limitations upon the extent to which reserves might be set up and deducted. These limitations are discussed in the chapters on deductions. While the language of the ruling refers particularly to corporations, there seems to be no reason why it should not be applicable to individuals as well.

109 Revenue Act of 1918, § 212 (b); Reg. 45, Art. 22. See Chapter 34 on Returns.

110 Reg. 45, Art. 23. Maryland Casualty Company v. U. S., 52 Ct. Cls. 201. This case is now No. 395 on the docket of the United States Supreme Court.

payers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. Among the essentials are the following: (1) In all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor inventories of the merchandise on hand (including finished goods, work in process, raw materials and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year; (a) Expenditures made during the year should be properly classified as between capital and income, that is to say, that expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and (3) In any case in which the cost of capital assets is being recoverd through deductions for wear and tear, depletion or obsolescence any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be charged against the property account or the appropriate reserve and not against current expenses.[111]

CHANGING FROM A CASH TO AN ACCRUAL BASIS. There seems to be no prohibition in the Revenue Act of 1918 against changing from a cash to an accrual basis, or vice versa; but it seems that approval of the return filed on the new basis by the Commissioner is necessary as it is within his province to determine if the change results in reflecting the taxpayer's true net income, particularly for the year in which the change occurs. The reporting of net income on the basis of book entries is no longer a privilege, but in computing net income a taxpayer follows the method regularly employed in keeping his books.[112]

111 Reg. 45, Art. 24; Reg. 33 Rev., Arts. 127, 128.

112 Revenue Act of 1918, § 212 (b). Under the 1916 Law it was ruled that the change from a cash to an accrual basis and vice versa

ACCRUED CHARGES. Under the 1916 Law it was permissible for a corporation which accrued on its books, monthly or at other stated periods, amounts sufficient to meet fixed annual or other charges, to deduct the amount so accrued, provided the accruals approximated as nearly as possible the actual liabilities for which the accruals were made, and income from fixed and determinable sources accruing to the corporation was returned on the same basis.[113] "Paid," or "actually paid," as referring to deductions, did not necessarily contemplate that there should be an actual disbursement in cash or its equivalent. If the amount involved represented an actual expense or element of cost in the production of the income of the year, it was properly deductible, even though not actually disbursed in cash, provided it was so entered upon the books of the company as to constitute a liability against its assets and provided further that the income was also returned upon an accrued basis. If in the course of its business, a corporation credited the accounts of individuals, firms, or corporations with the amount of any expenses, interest, rentals, wages, etc., due them, thereby making them subject to the personal drawings of such creditors, or if expenses actually incurred were vouchered in definite amounts, the amounts so credited or vouchered might be treated as paid, and if the amounts so credited or vouchered were expenses incurred concurrently with and in the production of the income of the year, they might be allowably deducted therefrom. The deduction of any accrued charges which if paid in cash or otherwise would not be deductible was not permitted.[114]

might be effected at any time, provided the method adopted be consistently followed from year to year (Letter from Treasury Department dated December 17, 1918; I. T. S. 1918, ¶ 3709).

113 T. D. 2433.

114 Reg. 33 Rev., Art. 126. Note the use of the words "paid or incurred" and "paid or accrued" in regard to the deductions permitted under the Revenue Act of 1918 (Revenue Act of 1918, §§ 214 and 234). "The terms 'paid or incurred' or 'paid or accrued' shall

Charged Against Current Earnings. All expenses, including interest, taxes, and other necessary charges, incidental and necessary to the creation or production of the gross income or properly chargeable against the same, being deductible from the gross income, whether paid in cash or entered on the books as a liability, could not, if unpaid, be carried forward to be deducted from the gross income of a subsequent year.[115]

Each Year's Return Complete. Net income must be computed with respect to a fixed period.[116] Each year's return, under the 1916 Law, both as to income and deductions therefrom, is required to be complete within itself. Charges, of whatever character, against income could not be cumulative. They were required to be deducted from the income of the year in which incurred, or not at all. The expenses, liabilities, or deficit of one year could not be used to reduce the income of a subsequent year. The deductions were required in all cases to be such as were authorized and within the limits fixed by law.[117]

Previous Year's Charges Not Deductible. A corporation having the right to deduct all authorized allowances, whether paid in cash or set up as a liability, it follows that if it did not within any year pay or accrue certain of its expenses, interest, taxes, or other charges, and made no deduction therefor, it can not deduct from the income of the next or subsequent year any amounts then paid in liquidation of the previous year's liabilities.[118] If, however, a corporation discovers or detects expenses or liabilities which were due and payable during a preceding year, it is permissible for it to make an amended return for the year to which such expense or liability applied, include

be construed according to the method of accounting upon the basis of which the net income is computed under Section 212." (Revenue Act of 1918, § 200.)

115 Reg. 33 Rev., Art. 127.

116 Reg. 45, Art. 22.

117 Reg. 33 Rev., Art. 127.

118 Reg. 33 Rev., Art. 128.

such expense in the deductions of that year, and file a claim for refund for any taxes overpaid by reason of failure to deduct such expense or liability in the original return of that year.[119]

[119] Reg. 33 Rev., Art. 128.

CHAPTER 17

INCOME FROM PERSONAL SERVICES

The law expressly provides that the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal services of whatever kind and *in whatever form paid*, or from professions or vocations.[1] It is to be noted that salaries, wages, or compensation for personal services are taxable income "in whatever form paid." Where services are paid for in something other than money, the fair market value of the thing taken in payment is income.[2] This is one of the three cases in which the law expressly specifies that the tax shall be based upon payments other than in cash, the others being the provision relating to dividends[3] and the provision relating to exchanges of property.[4] Payment of salaries, wages, etc. in the form of living quarters, board or lodging, is referred to in the preceding chapter.

Salaries. Under the 1916 Law it was held that salaries should be reported in the year in which actually received and not necessarily in the year in which earned. Under the present law it seems the salary will be considered as income of the year in which earned if the amount is determined in that year and paid in the following year merely by reason of delay incident to delivery of the cash or check in due course. A salary paid by a corporation which is itself exempt from the income tax is neverthe-

1 Revenue Act of 1918, § 213 (a).
2 Reg. 45, Art. 32.
3 Revenue Act of 1918, §§ 213 (a) and 201.
4 Revenue Act of 1918, § 202 (b).

less subject to tax in the hands of the employee.[5] In the case of corporations, so-called "salaries" of stockholders, if unreasonable in amount and if based on the amount of stock held, are considered to be distribution of the net profits of the corporation, not deductible as a business expense of the corporation, and, therefore, not subject to the normal tax in the hands of the recipient.[6]

Bonuses and Profit Sharing. Where employees receive bonuses, or are entitled to a share of the profits of the employer the amount so received should be included as income, provided (a) it is clearly made as compensation for services rendered and (b) it is paid under a contract, express or implied, or a long time practice, (practically an implied contract), regularly employed, which constitutes a condition, if not a contract, under which the employees may reasonably expect additional pay for the greater or better services which they render, or (c) the total amount of salary and bonus is not greater than a reasonable compensation for the services rendered by the employee.[7] Such payments are income to the employee if they are of such character that the employer is entitled to deduct the same as an expense of doing business. If the bonus is a mere gift, the employee should not treat the amount as income, since gifts or gratuities are not taxable, and the employer is not entitled to deduct the amount from his income as an expense of doing business. The rules governing the deduction of bonuses and profit sharing payments are more fully treated under the heading of deductions, which should be read in this connection.[8] The rule to be followed by the employee is that if the employer is entitled to deduct the amount as an expense of doing business, the employee should return the amount as income, and, *vice versa,* if the employer is not entitled to deduct the amount as expense, the employee should not return the amount as income,

[5] T. D. 2135; T. D. 2090.
[6] Reg. 45, Art. 106; T. D. 2696. See p. 436.
[7] Reg. 45, Art. 107; T. D. 2696. See p. 439.
[8] See Chapter 28 on Deduction of Business Expenses.

otherwise the same sum of income would be taxed twice.[9] If so-called bonuses or profit sharing are paid to stockholders of corporations, which are in fact distributions of net profits based on stock holding, they will be considered as dividends and held to be taxable as such.[10]

Salaries of Partners. As a general rule members of a general partnership are not entitled to salaries, and the Treasury Department will not recognize the payment of salary to a partner unless such salary is provided for in the articles of partnership or by express contract.[11] The question is not of very great importance under the income tax law under which partnerships are not taxed as entities. It assumed importance under the 1917 excess profits tax, for which tax partnerships were allowed to deduct amounts representing a reasonable allowance for salaries of partners.[12]

Voluntary Offerings Received by Clergymen. Although as a general rule gifts and gratuities are not income, yet Easter offerings, and fees received by clergymen for funerals, masses, marriages, baptisms, etc., are considered income, because though in the form of gifts they are in fact payment to the clergymen, evangelists, and religious workers for services rendered.[13] Chirstmas gifts to clergymen do not come within this category.[14] The rule to be observed is whether or not the money is actually a gift or merely in the form of a gift.

Commissions. Commissions paid or credited or made available to salesmen are income, which should be accounted for in the return of the person receiving the same in the year in which received or the year in which such commis-

9 One exception is made to this rule by the Treasury Department. See p. 438.

10 Reg. 45, Art. 106; T. D. 2696.

11 Letter from Treasury Department dated March 19, 1917; I. T. S. 1918, ¶ 664.

12 Reg. 41, Art. 32.

13 Reg. 45, Art. 32.

14 T. D. 2090.

sions were credited or made available to the recipient salesmen so as to be constructively received.[15]

Compensation for Services Extending Over a Year. Where no determination of compensation is had until the completion of the services, the amount received is ordinarily income for the calendar year of its determination or receipt.[16] It was held under the 1916 Law that if no determination has been made of the amount due the trustee of an estate, as compensation for his services over a period of years, until the trust was terminated, the amount allowed him should be returned in full as income for that year, and it should not be pro-rated over the length of time the services were rendered.[17]

Compensation to Federal Government Officers and Employees. Compensation received as such by officers and employees whether elected or appointed of the United States, or of Alaska, Hawaii or any political subdivision thereof, or the District of Columbia is subject to tax whether paid in cash or in other forms.[18] The entire sum received, however, is not necessarily taxable as will be indicated in the following paragraphs.[19]

LIVING QUARTERS. Commutation of quarters and the money equivalent to quarters furnished in kind should be returned as income. When quarters are furnished in kind of a less number of rooms than the number allowed by law, the money equivalent only of the number of rooms actually assigned should be returned as income. When quarters are furnished of a greater number of rooms than the number allowed by law, it is to be assumed that the excess number is assigned for the convenience of the Gov-

15 Reg. 45, Art. 32; T. D. 2090; Letter from Treasury Department, dated April 30, 1918; I. T. S. 1918, ¶ 3342.

16 Reg. 45, Art. 32. This point is more fully discussed in Chapter 16 on Income—In General.

17 T. D. 2135.

18 Revenue Act of 1918, § 213 (a).

19 T. D. 2079.

ernment, and the money equivalent only of the number of rooms allowed by law should be returned as income.[20]

HEAT AND LIGHT. Amounts received by, or paid for, an officer for heat and light should be returned as income. This includes the money equivalent, as fixed by the Government, of heat and light furnished to an officer occupying public quarters.[21] Amounts expended for heat and light are in the nature of personal living expenses and differ in this respect from amounts furnished for mileage, the latter being in the nature of a business expense or an expense of the employer rather than of the employee.

MILEAGE. Mileage, as such, is not income to an officer or employee, as he is required to pay his actual expenses while traveling under mileage orders. The difference between the amount received as mileage and the amount of actual necessary expenses incurred on a journey should, however, be returned as income. The actual expenses to be deducted by the individual before ascertaining his income on account of mileage are the expenses for which reimbursement would be made by the Government if he had traveled on an actual expense basis instead of a mileage basis.[22]

REIMBURSEMENT FOR ACTUAL EXPENSES. Amounts paid by the Government in the nature of reimbursement for subsistence and other items of actual expense incurred while absent on business for the Government are not required to be returned as income.[23]

PER DIEM ALLOWANCES. The total per diem allowance is income and there may be taken as a deduction for expense, the amount actually expended from such allowance for actual necessary traveling expenses.[24]

Compensation of Officers and Employees of a State or Political Subdivision Thereof. The Revenue Act of 1918, does not expressly exempt "the compensation of all officers

20 T. D. 2079.
21 T. D. 2079.
22 T. D. 2079.
23 T. D. 2079.
24 Reg. 33 Rev., Art. 8; T. D. 2079; T. D. 2124.

and employees of a state, or any political subdivision thereof, except when such compensation is paid by the United States Government," as did the 1916 Law.[25] It would seem, therefore, that such compensation is intended to be made taxable,[26] but the Treasury Department has ruled

[25] Revenue Act of 1916, § 4.

[26] The general opinion that a federal tax on the salaries of officers or employees of a state is unconstitutional, is based on the case, among others, of Collector v. Day, 11 Wall. 113. In this case Day, who was Judge of the Court of Probate and Insolvency for a county in Massachusetts, was taxed on his salary in 1866 and 1867 as such officer. The question was presented "whether or not it is competent for Congress, under the Constitution of the United States, to impose a tax upon the salary of a judicial officer of a State." The court considers at some length the case of Dobbins v. Erie Co., 16 Pet. 435, in which it was decided that a State could not levy a tax on the salary of an officer of the United States, because (1) such officer was a means or instrumentality employed for carrying into effect some of the legitimate powers of the Federal Government which could not be interfered with by the States, (2) the salary or compensation for the service of the officer was inseparably connected with the office, and (3) if the officer was exempt, his salary was equally exempt. The court also considered at some length the leading case of McCullough v. Maryland, 4 Wheat. 316, and discussed the relationship between the Federal Government and the separate states. Conceding that the exemption of the salaries in question from income tax rested upon "necessary implication," the court placed its decision on the grounds that (1) in respect to the powers reserved to them, one of which was the power to maintain a judicial department, the separate states are as sovereign and independent as the Federal Government, (2) that the unimpaired existence of such reserved powers is as essential in one case as in the other, and (3) the means and instrumentalities employed by the States for carrying on the operations of their governments, for preserving their existence and for fulfilling the duties assigned to them by the Constitution, must be left free and unimpaired and must not be crippled or defeated by another taxing power. Opinion to the contrary is founded largely upon the recent cases of Peck v. Lowe, 247 U. S. 165, and U. S. Glue Co. v. Oak Creek, 247 U. S. 321. The bill as introduced into Congress expressly taxed such salaries, but the provision was stricken out in the Senate, and not restored by the Conference Committee, although that committee restored the provision taxing the salary of the President and salaries of federal judges.

that it is not taxable.[27] The exemption under the 1916 Law applied to officers and employees of the state and of its counties, municipalities, townships and other political subdivisions. The salaries of public school teachers came within this class.[28] An individual who entered into a contract with a state, or any political subdivision thereof, for the doing of a thing or things specified by the contract, the completion of which would constitute a fulfillment of the contract on the part of such individual, was held not to be an officer or employee of the State or political subdivision thereof, and the amount received by him from the State or political subdivision thereof under the terms of the contract was required to be accounted for as income.[29] The exėmption did not include an individual who entered into a contract with a state for the construction of public works, as such person is neither an officer nor an employee.[30] It was also ruled that where a real estate corporation was employed by a city to appraise the value of property, it could not claim exemption as an employee. Officials of the governments of the District of Columbia, Porto Rico and the Philippine Islands, or the political subdivisions thereof, did not come within this class under the 1916 Law and the compensation paid to them was not exempt.[31] The Treasury Department holds under the present law that compensation paid its officers and employees by a State of political subdivision thereof, fees received by notaries-public commissioned by States, and the income of State workmen's compensation insurance funds established by state statutes is not taxable; and that employees of universities, who are officers or employees of a State, receiving salaries paid in part or in whole from funds available under the Smith-

27 Reg. 45, Art. 71.
28 Reg. 33, Art. 5.
29 Reg. 33 Rev., Art. 4.
30 T. D. 2152. See Revenue Act of 1918, § 213 (a) (7).
31 Revenue Act of 1916, § 23.

Lever Act of May 8, 1914, are not required to return as taxable income the salaries so received.[32]

Compensation of Federal Judges. The salaries of Judges of the Supreme Court and inferior courts of the United States, in office at the time the law was passed, were exempt from the tax, under the 1916 Law, but this did not include the salaries of such judges as were appointed subsequent to the passage of the law, or to retired judges.[33] The Revenue Act of 1918 expressly taxes the compensation of all federal judges.[34]

Compensation of the President of the United States. Under the 1916 Law, the compensation of the President of the United States in office at the time the law was passed was exempt from the tax during the term for which he was elected.[35] Compensation received as such by the President

[32] Reg. 45, Art. 71.

[33] Revenue Act of 1916, § 4; T. D. 2090. This exemption was inserted in view of the provision of the Federal Constitution, Art. 3, § 1, which guarantees that the compensation of Federal judges shall not be diminished during their continuance in office. See Opinion of Justice Field in Pollock v. Farmers Loan & Trust Company, 157 U. S. 429; and 13 Op. Atty. Gen. 161. On February 16, 1863, Chief Justice Taney, of the United States Supreme Court, wrote a letter to Hon. S. P. Chase, then Secretary of the Treasury, vigorously protesting against the constitutionality of any construction of the income tax then in force to embrace a tax on the salaries of the Judges of the Supreme Court. The Secretary of the Treasury, having ignored this letter, Chief Justice Taney procured its entry on the records of the Supreme Court on March 10, 1863 (Tyler's Life of Taney, Pp. 432, 435). It was deemed unpatriotic to resist the collection of the tax, at least during the war and it was collected until toward the end of 1869 when the opinion of the Attorney-General referred to above was rendered, advising against the constitutionality of any tax upon the salary of the President of the United States and upon the Judges of the Supreme Court. An interesting question is presented as to how this question of constitutionality can be determined with propriety, since the judges of the courts which have jurisdiction of the question also have an interest therein.

[34] Revenue Act of 1918, § 213 (a).

[35] Revenue Act of 1916, § 4. In an opinion of the Attorney General in 1869 it was held that a specific tax by the United States upon the salary of the President in office at the time the act was passed, to

of the United States is expressly taxable under the 1918 Law.[36]

Professions and Vocations. Incomes from professions and vocations are taxable as is income from any other source. No rulings are specially applicable to these forms of income. Such income is taxable in the year in which it is received, not necessarily for the year in which it is earned. Rulings as to this point are general and are discussed in the preceding chapter.

be deducted from the salary which otherwise would be paid him, would be a diminution of his compensation in contravention of Article 2, Section 1, Clause 7, of the Federal Constitution, which provides that the compensation of the President shall neither be increased or diminished during the period for which he shall have been elected. 13 Op. Atty. Gen. 162. This consideration no doubt moved Congress to grant the exemption in the 1916 Law.

36 Revenue Act of 1918, § 213 (a).

CHAPTER 18

INCOME FROM BUSINESS, TRADE OR COMMERCE

Income from this source is, as indicated in the title, the income derived by an individual or a corporation from business, trade or commerce in which he or it is engaged.

Inventories. The requirements under the 1918 Law in regard to inventories are fully treated in another chapter.[1] Under the 1916 Law where a physical inventory was impossible and an equivalent inventory was equally accurate, the latter was accepted. An equivalent inventory is an inventory of materials, supplies, and merchandise on hand taken from the books of the taxpayer.[2]

Gross Income of Insurance Companies. Special rules are applicable to ascertaining the gross income of insurance companies. These rules are discussed in the chapter on insurance companies.[3]

Gross Income Generally. The gross income of the taxpayer is, generally speaking, his total income derived from the operation and management of his or its business and property, together with all amounts of income from all other sources. It embraces, of course, not only the income of a manufacturer or dealer from his business, but also income from all other sources such as rentals, royalties, interest, dividends, and profits from the sale of assets.[4]

1 See Chapter 16 on Income—In General.

2 Reg. 33, Art. 161.

3 See Chapter 13 on Special Provisions Applying to Insurance Companies.

4 Reg. 45, Art. 21; Reg. 33 Rev., Art. 93; Reg. 33, Arts. 106 and 107.

Income of Contractors. Persons engaged in contracting operations, who have uncompleted contracts, in some cases perhaps running for periods of several years, will be allowed to prepare their returns so that the gross income will be arrived at on the basis of completed work; that is, on jobs which have been finally completed any and all moneys received in payment will be returned as income for the year in which the work was completed. If the gross income is arrived at by this method, the deduction from gross income should be limited to the expenditures made on account of such completed contracts. Or the percentage of profit from the contract may be estimated on the basis of percentage of completion, in which case the income to be returned each year during the performance of the contract will be computed upon the basis of the expenses incurred on such contract during the year; that is to say, if one-half of the estimated expenses necessary to the full performance of the contract are incurred during one year, one-half of the gross contract price should be returned as income for that year. Upon the completion of a contract if it is found that as a result of such estimate or apportionment the income of any year or years has been overstated or understated, the taxpayer should file amended returns for such year or years.[5]

Income from Export Business. Under the 1916 Law income from the business of exporting goods was held to be taxable by the Treasury Department. It has also been held that a tax on such income is not a tax on the articles exported, and therefore not unconstitutional in that regard, since if Congress has power to lay a tax up to the time when articles are put in course of exportation, the conclusion is unavoidable that the net income arising from exportation when it has been completed or after the exportation and sale are fully consummated, is likewise subject to taxation under general laws.[6]

[5] Reg. 45, Art. 33; Reg. 33 Rev., Art. 121; T. D. 2161.
[6] Peck v. Lowe, 247 U. S. 165.

Discounts. The discount allowed to a corporation purchasing new equipment need not be reported as income, but the cost of the equipment as charged to capital must represent only the net cost after making allowance for the discount in question.[6a]

Bank Discounts. In cases wherein banks or other corporations loan money by discounting bills or notes, one of two methods shall be used in determining the amount of discount that is to be reported as income, namely (1) if the bank or corporation makes a practice of crediting such discount directly to a "discount account" or to profit and loss, and total amount thus credited during the year shall be considered income and shall be so reported, regardless of the fact that a portion of this amount may represent discount paid in advance and not then earned; (2) if the bank or corporation follows the practice of crediting such discount to an "unearned discount account," and later, as the discount becomes earned, debits the unearned account and credits an "earned discount account" with the amount so earned, the total amount credited to the "earned discount account" during the year shall be considered income and shall be so returned. The corporation having income of this character should state in a memorandum attached to its return which of the two methods was used in determining the amount of discount returned as income.[7]

Payment by Installment. If payments for goods sold are made in installments by the buyer, a proportionate part of each installment represents the profit on the sale of the goods and the rest represents a return of capital to the seller. The manner of treating the income arising on the payment on such installments is described in a later chapter.[8]

Income from Business of Certain Public Utilities May Be Exempt. The Revenue Act of 1918 expressly exempts

[6a] Letter from Treasury Department dated November 26, 1918; I. T. S. 1918, ¶ 3698.

[7] Reg. 33 Rev., Art. 114.

[8] See Chapter 20.

from tax any income derived from any public utility or from the exercise of any essential governmental function and accruing to any State, Territory or the District of Columbia or any political subdivision of a State or Territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof. It further provides that whenever any State, Territory or the District of Columbia or any political subdivision of a State or Territory has, prior to September 8, 1916, entered in good faith into a contract with any person the object and purpose of which is to acquire, construct, operate or maintain a public utility, no tax shall be levied upon the income derived from the operation of such public utility so far as the payment thereof will impose a loss or burden upon such State, Territory, District of Columbia or political subdivision; but this provision does not confer upon such person any financial gain or exemption or relieve any such person or corporation from the payment of a tax as provided for in the law upon the part or portion of such income to which such person or corporation is entitled under the contract.[9]

[9] Revenue Act of 1918, § 213 (b) 7.

CHAPTER 19

INCOME FROM FARMING

Special rules have been made with respect to farming and farmers.[1] In connection therewith the term "farming" is defined as embracing the farm in the ordinary accepted sense and includes plantations, ranches, stock farms, dairy farms, poultry farms, fruit farms, truck farms and all land used for similar purposes; and the term "farmer" is defined as all corporations, partnerships or individuals who cultivate, operate, or manage such farms for gain or profit, either as owners or tenants.

"Gentlemen Farmers." A person cultivating or operating a farm for recreation or pleasure, on a basis other than the recognized principles of commercial farming, the usual result of which is a loss from year to year, is not regarded as a farmer. In such cases, if the operation of a farm results in a net gain for the year, such gain must be included. If, however, the expenses and losses incurred in connection with the farm are in excess of the receipts the entire receipts from the sale of products may be omitted from the return of income; and the expenses, being regarded as personal expenses, will not be allowed as a deduction from income derived from other sources.[2]

Farmers Keeping Books and Taking Inventories. Farmers who keep books according to approved methods of accounting, which clearly show net income, and take annual inventories may, if the same method is consistently followed from year to year, prepare their returns in ac-

1 Reg. 45, Arts. 35, 110, 145, 172; T. D. 2665, amending T. D. 2153. Reg. 33 Rev., Arts. 4 and 123.

2 Reg. 45, Art. 35; Reg. 33 Rev., Art. 4.

cordance with the showing made by their books and inventories.[3]

Inventories. If the inventory method is adopted, the farmer should, in order to ascertain gross income, add to the amount received from sales made during the year, the inventory of the live stock and products on hand at the close of the year and from this sum deduct the amount expended in purchasing live stock and products plus the inventory of the live stock and products at the beginning of the year. The inventory at the begnining of the year must be the same figure as at the close of the next preceding year and (a) it *must* include the cost of live stock or products purchased for resale, (b) it *may* include live stock and products produced on the farm and still on hand. Where gross income is ascertained by inventory, no deduction can be made for live stock or products lost during the year, whether purchased for resale or produced on the farm, as such losses will be reflected in the inventory by reducing the amount of live stock or products on hand at the close of the year. Live stock purchased for draft, breeding, or dairy purposes, or for any purpose other than resale, may be included in the inventory for each year at a figure which will reflect the reduction in value estimated to have occurred during the year through increase of age or other causes. Such reduction in value should be based on the cost and estimated life of the live stock. In the case of loss of such live stock no deduction can be made, as the loss will be reflected in the inventory at the close of the year. When the inventory method is used, the cost price of the article sold must not be taken as an additional deduction, as it is reflected in the inventory.[4]

[3] Reg. 45, Art. 35; T. D. 2665. See Chapter 16 on Income—In General for the rules in regard to inventories generally.

[4] Reg. 45, Art. 35; T. D. 2665. This Treasury decision uses the expression "stock purchased for draft, breeding or dairy purposes or for any purpose other than resale" for the first time. The intention is apparently to extend the expression "stock used for breeding purposes" used in former rulings to all stock not purchased for resale.

Accounting on an Accrual Basis. Farmers keeping books are required to report their income on the cash or accrual basis, according to the method of accounting employed by them in keeping their books.[5] This subject is discussed elsewhere in this book.[6]

Farmers Not Keeping Books and Not Taking Inventories. All farmers not keeping books and taking inventories must report on the basis of actual receipts and disbursements, in order that their returns may be susceptible of audit for the purpose of verification.[7]

Income. The income of a farmer may be in cash or in kind; that is, like that of any other individual or corporation subject to tax, it may consists of money or of a money equivalent. In general, the income of a farmer may be said to be determined according to the same principles which determine the income of other taxable individuals or corporations, but certain special rules are set forth in the following paragraphs.

Value of Products Consumed by Farmer. A farmer is not required to report as income the value of farm products consumed by himself and family.[8]

Income from Rents Received in Kind. Rents received in crop shares are to be reported as income in the year in which the crop shares are sold or otherwise reduced to money or a money equivalent.[9]

Income from Sale of Annual Produce. All gains, profits and income derived from the sale of annual produce, whether produced on the farm or purchased and

5 Revenue Act of 1918, § 212; T. D. 2665; T. D. 2433.

6 See Chapter 16.

7 T. D. 2665. See Chapter 16 on Income—In General for a general discussion of this subject.

8 Under this rule a farmer may use 100 bushels of potatoes for himself and family without being subject to tax, but if he should sell the potatoes, and use the proceeds in buying other potatoes for his family, he would be taxable. This rule seems incongruous, but may be the only practicable one in the circumstances.

9 Reg. 45, Art. 35; Reg. 33 Rev., Art. 4.

resold by the farmer, must be reported as income for the year in which the product is actually marketed and sold unless the inventory method is used. Where a farmer exchanges farm produce for merchandise, groceries, or mill products, the market value of the article or property received should be reported as income.[10]

INCOME FROM SALE OF LIVE STOCK. For the purpose of this discussion live stock may be divided into three classes: (1) live stock raised on the farm, (2) live stock purchased by the farmer for the purpose of resale at a later time, and (3) live stock raised or purchased for draft, breeding or dairy purposes, or any purpose other than resale. Where a farmer keeps books and carries the value of his live stock in annual inventories, the total amount received on the sale of any such stock should be entered on his books as gross receipts, and the income therefrom will be reflected through the inventories.[11] Where the farmer does not keep books and take inventories, the profit or income from the sale of live stock is, generally speaking, the difference between the cost thereof and the amount received on the sale.[12] This general rule is, however, subject to several qualifications or exceptions, as follows:

(a) When the live stock was owned on March 1, 1913. If the live stock was owned by the farmer on March 1, 1913, whether raised on the farm or purchased, the fair market price or value on that date is to be deducted from the selling price; and the cost, if any, is disregarded.[13]

(b) When the live stock was raised on the farm. If

10 Reg. 45, Art. 35; T. D. 2665. The rulings do not cover cases where farm products are exchanged or bartered for other articles or property having no definitely ascertainable market value, as, for instance, the exchange of one horse for another; and it would seem no taxable income accrues to either party in such transaction. See Chapter 16 on Income—In General.

11 T. D. 2665. The rulings permit, but do not require the value of live stock raised on the farm to be carried in inventory.

12 Of course, if the selling price is less than the cost the result will be a loss.

13 See Chapter 20.

the live stock was raised on the farm, the farmer has no purchase price to deduct and the entire selling price is income, unless the live stock was owned on March 1, 1913, in which case the rule stated in the preceding paragraph will apply. The cost of raising such stock is not deducted from the selling price, since such cost is an annual expense, which should be deducted from year to year, as incurred.

(c) When the live stock has been purchased. When the live stock has been purchased, the purchase price thereof should be deducted from the selling price, unless the stock was acquired before March 1, 1913, in which case the rule stated in paragraph above will apply. The expense of care, feeding and marketing such stock is not deducted from the selling price, but is treated as an item of annual expense.[14] A special rule may apply in the cases referred to in this paragraph. Under a former regulation of the Treasury Department [15] a farmer was permitted to charge to expense the cost of live stock purchased for resale. Where the cost of live stock was charged to expense and claimed as a deduction under that regulation in any past year, the entire proceeds from the sale of the same must now be considered as income for the reason that the farmer is not again entitled to the benefit of the deduction which he has already received.[16]

(d) Live stock used for draft, breeding or dairy purposes. Where live stock has been purchased or raised for draft, breeding or dairy purposes, and is sold, the income is ascertained in the manner indicated in the preceding paragraph, unless the farmer has claimed a deduction for depreciation on such stock in any year.[17] In such cases the aggregate amount allowed for depreciation in preceding

[14] T. D. 2665.

[15] T. D. 2153, dated February 12, 1915.

[16] T. D. 2665. In such cases, however, it seems the return for the year in which the stock was purchased might be amended to conform to present rulings and the return for the year in which the stock was sold prepared accordingly.

[17] See Page 348 for rules regarding Depreciation.

years must be added to the selling price in order to ascertain the taxable profit.[18] Thus, if a horse was purchased for $500 and $35 has been claimed for depreciation in each of three years, where the horse is sold for $550, the taxable profit would be ascertained by adding the depreciation for three years, amounting to $105, to the selling price, making a total of $655, and subtracting from such total the purchase price, of $500, leaving a taxable profit of $155.

INCOME FROM SALE OF OTHER FARM PROPERTY. Income from the sale of other farm property should be reported in accordance with the general rules set forth in another chapter.[19]

INCOME FROM OTHER SOURCES. If the cost of produce, live stock or other property which has been lost or destroyed is deducted as a loss and subsequently the farmer is reimbursed in whole or in part by the state or federal authorities (e. g. where the stock has been killed to avoid the spreading of disease) or by insurance or indemnity, the amount so received as reimbursement is income.[20] This contemplates a case where the loss may have been deducted in one year and the reimbursement is received in another year. It is allowable, however, and advisable that no loss be claimed in such cases until the reimbursement has been received, as until that time the net loss is not ascertainable. When the reimbursement is received, it should then be treated the same as though it represented the selling price and the gain or loss determined according to the rules set forth in the preceding paragraphs relative to sales. If a farmer works out his road or other taxes and claims such taxes as a deduction he must also include the same amount as income, as by the work he earns sufficient to pay the taxes. If he does not claim deduction for such taxes he need not include a corresponding amount as income. Of course, any income received by the farmer from

[18] See Page 351.
[19] See Chapter 20.
[20] Reg. 33 Rev., Arts. 4 and 123.

investments or other sources must be added to the income he received from farming in order to ascertain his total tax liability. If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may be computed upon the crop basis; in any such case the entire cost of producing the crop must be taken as a deduction in the year in which the gross income from the crop is realized.[21]

Deductions. The special rules in regard to the deductions permitted to farmers are set forth in the following paragraphs.

EXPENSE. A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools, of short life or small cost, such as hand tools, including shovels, rakes, etc., may be included. The cost of feeding and raising live stock may be treated as an expense deduction, in so far as such cost represents actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. Where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may be determined upon the crop basis, and such deductions must be taken in the year in which the gross income from the crop has been realized. The cost of farm machinery and farm buildings represents a capital investment and is not an allowable deduction as an item of expense. Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached constitute investments of capital. The amount expended in purchasing draft or work animals or live stock either for resale or for breeding purposes is regarded as an investment of capital. The purchase price of an automobile, even when wholly used

21 Reg. 45, Art. 35.

in carrying on farming operations, is not deductible and it is regarded as an investment of capital. The cost of gasoline, repairs, and upkeep of an automobile if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned in accordance with the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to use for business purposes alone is deductible as a necessary expense.[22]

INTEREST. The rules respecting the deduction of interest by farmers do not differ from the rules respecting the deduction of interest by other individuals and corporations subject to tax, and are discussed elsewhere in this book.[23]

TAXES. In general, the rules respecting the deduction of taxes by farmers are the same as the rules respecting the deduction of taxes by other individuals or corporations subject to tax, and are discussed elsewhere in this book.[24] Farmers who work out road or other taxes may

[22] Reg. 45, Art. 110. Under Reg. 33 Rev., Art. 4 and T. D. 2153, dated February 12, 1915, the deduction of expenses in the return *for the year* in which they were made even though the crops and stock in connection with which they were incurred may not have been marketed during the year for which the return was rendered, was only permissible. Where under the former rulings a farmer has not deducted the cost of producing the farm products he may deduct the same from the selling price and report only the difference as income. T. D. 2665 now *limits* such deduction to the year in which the expenditures were made. It was formerly held that the cost of stock purchased for resale might, at the option of the farmer, be deducted as an expense, or taken into consideration upon the sale of such stock, but that money expended for stock for breeding purposes was, as now, to be regarded as capital invested and therefore not deductible, except as the stock depreciated in value. (See also Reg. 33 Rev., Arts. 4 and 123.)

[23] See Chapter 28 on Deduction of Interest.

[24] See Chapter 29 on Deduction of Taxes.

deduct the amount thereof, but if they do they must also include the same amount as income.

LOSSES. Losses incurred in the operation of farms as business enterprises are deductible from gross income. If farm products are held for favorable markets, no deduction on account of shrinkage in weight or physical value or by reason of deterioration in storage shall be allowed. The total loss by frost, storm, flood or fire of a prospective crop, or of a crop which has not been sold, is not a deductible loss in computing net income. A farmer engaged in raising and selling stock, cattle, sheep, horses, etc., is not entitled to claim as a loss the value of animals that perish from among those animals that were raised on the farm. If live stock has been purchased for any purpose, and afterwards dies from disease, exposure or injury, or is killed by order of the authorities of a State or the United States, the actual purchase price of such stock, less any depreciation which may have been previously claimed with respect to such perished live stock, less also any insurance or indemnity recovered, may be deducted as a loss. The actual cost of other property, less depreciation already allowed, destroyed by order of the authorities of a State or of the United States may in like manner be claimed as a loss; but if reimbursement is made by a State or the United States, in whole or in part, on account of stock killed or property destroyed, the amount received shall be reported as income for the year in which reimbursement is made. In determining the cost of stock for the purpose of ascertaining the deductible loss there shall be taken into account only the purchase price, and not the cost of any feed, pasturage, or care which has been deducted as an expense of operation. If gross income is ascertained by inventories, no deduction can be made for live stock or products lost during the year, whether purchased for resale or produced on the farm, as such losses will be reflected in the inventory by reducing the amount of live stock or products on hand at the close of the year. If an individual owns and operates a farm, in addition to being engaged in another trade, business, or

calling, and sustains a loss from such operation of the farm, then the amount of loss sustained may be deducted from gross income received from all sources, provided the farm is not operated for recreation or pleasure.[25]

DEPRECIATION. A reasonable allowance for depreciation may be claimed on farm buildings (other than a dwelling occupied by the owner), farm machinery, and other physical property, including live stock purchased for draft, dairy, or breeding purposes, but no claim for depreciation on live stock raised or purchased for resale will be allowed. Live stock purchased for draft, breeding or dairy purposes, or for any purpose other than resale may be included in the inventory for each year at a figure which will reflect the reduction in value estimated to have occurred during the year through increase of age or other causes. Such a reduction in value should be based on the cost and estimated life of the live stock. If an inventory is not used, a reasonable allowance for depreciation may be claimed based upon the cost of draft and work animals and animals kept solely for breeding purposes and not for resale.[26]

DEPLETION. Farmers are permitted the same allowance for the exhaustion of natural deposits as other individuals and corporations. This subject is treated elsewhere in this book.[27]

Returns of Farmers. Farmers are required to make returns of annual income and annual or special returns with respect to withholding at the source, information at the source, and other matters in the same manner and according to the same rules as those prevailing in the case of all individuals and corporations. This subject is treated elsewhere in this book.[28] In addition to the annual return of income, farmers are required to prepare and file

[25] Reg. 45, Art. 145; Reg. 33 Rev., Arts. 4 and 123; T. D. 2665.

[26] Reg. 45, Art. 172; Reg. 33 Rev., Arts. 4 and 123. See Chapter 31 on Depreciation.

[27] See Chapter 32 on Depletion.

[28] See Chapter 34 on Returns.

a "schedule of farm income and expenses" (Form 1040 F) copies of which may be obtained from the local collector.

Payment of Tax; Penalties. Farmers pay the tax in the same manner as other individuals and corporations.[29] They are also subject to all the penalties which may be imposed upon other individuals and corporations.[30]

[29] See Chapter 35 on Assessment and Payment of Tax.
[30] See Chapter 36 on Penalties and Compromises.

CHAPTER 20

INCOME FROM SALES OR DEALINGS IN PROPERTY

The law expressly provides that gains, profits and income derived from sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property, shall be taxable.[1] It has been argued that gains resulting from an increase in capital should not be taxed, in cases where an owner was not engaged in the business of dealing in such property, but the language of the statute is broad enough to indicate that Congress intended the tax to apply to all transactions whether or not the taxpayer is a dealer.[2] A leading case[3] construing the income tax act of 1864 held that the gain to

[1] Revenue Act of 1918, § 213 (a).

[2] In Doyle v. Mitchell Brothers, 247 U. S. 179, decided under the 1909 Law, the Court said: "'Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received 'from all sources.'" Although the plaintiff in this case was not a real estate trading corporation the court proceeded on the assumption that certain of the proceeds of a conversion of stumpage lands should be treated as income, the difficult question at issue being to differentiate between the capital and income of such proceeds. In Hays v. Gauley Mountain Coal Co., 247 U. S. 189, although the plaintiff was not engaged in the business of trading in stocks and did not have such business among its corporate powers, the court held that so much of the profits from a sale of certain stock as might be deemed to have accrued subsequent to December 31, 1908, must be treated as gross income. See also U. S. v. Cleveland &c. Ry. Co., 247 U. S. 195. These cases, however, construed the 1909 Law, which was not an income tax law, but a law imposing an excise tax.

[3] Gray v. Darlington, 15 Wall. 63.

an individual resulting from the sale of property, purchased by him several years before, was not taxable, on the theory that the increased value of the property could not be said to be gain in any particular year of the time during which it was held.[4] It has been argued that the rule laid down in this case should be applied to the present law, but the language of the statute under which the case was decided differs considerably from the language of the 1909, 1913, 1916 and 1918 Laws and it is not certain whether such a rule would be applied to the construction of the present statute. The intent of the 1913 and 1916 Laws and the Revenue Act of 1918 seems clearly to be that gains from sales or dealings in property, regardless of whether the property is sold in the course of a business or trade or otherwise, shall be taxed.[5] It has been held by the Treasury Department that gains and profits resulting from a sale of property are subject to tax.[6] The gain, profit or income is the amount by which the selling price exceeds the cost. Book values[7] are ignored where they do not represent the actual cost of the properties. The entire profit is taxable unless the property was acquired prior to the incidence of the tax.[8]

Cost of Property. The cost of property is the actual price paid for it at the time of purchase, together with the expense of procuring it and the expense of selling it. Interest should not be added to the purchase price in order to ascertain cost.[9] If improvements or betterments

[4] It is stated by Mr. Justice McKenna in Lynch v. Turrish, 247 U. S. 221, that the case of Gray v. Darlington decided that such an advance in value is not income at all, but merely increase of capital and not subject to tax as income.

[5] Revenue Act of 1918, § 213 (a).

[6] T. D. 2090, T. D. 2137.

[7] See Doyle v. Mitchell Brothers, 247 U. S. 179; U. S. v. Guggenheim Exploration Co., 238 Fed. 231; Forty-Fort Coal Co. v. Kirkendall, 233 Fed. 704, upon the question of the weight to be attached to book entries.

[8] T. D. 2090; Letter from Treasury Department dated August 14, 1914; I. T. S. 1918, ¶ 395.

[9] Hays v. Gauley Mountain Coal Co., 247 U. S. 189.

have been made the cost of such improvements or betterments may also be added to the cost of the property.[10] It is also permissible to add to the initial cost of the property carrying charges provided they are such as have been capitalized and not deducted from net income in any annual return of the owner subsequent to the income tax.[11] Such cost must be reduced by the amount of any depreciation deducted from net income since February 28, 1913.

PROFIT NOT BASED ON BOOK VALUES. The values at which property is carried on the books of the owner is not conclusive evidence of its actual value. Where the Government attempts to impose a tax upon the difference between the book value and selling price, the taxpayer may show by other evidence the actual cost thereof or the actual value at the incidence of the tax.[12]

SHARES OF SAME STOCK BOUGHT AT DIFFERENT PRICES. When various parcels of stock of the same issue are bought and sold on different dates and at different prices, the shares sold should be identified, if possible, by the numbers of the certificates covering them, and the cost of the identical shares should be deducted in order to determine the profit. Where it is impossible to identify the shares in this manner, the shares should be considered to be sold in the order in which they were purchased, that is, the cost of the first shares purchased should be deducted from the selling price of the first shares sold.[13]

PROPERTY ACQUIRED BY A CORPORATION FOR STOCK. In cases where property was taken over by a corporation in exchange for its capital stock, at a par value greatly in excess of the true value of the property, and such property is later sold, it has been held by the Treasury De-

10 T. D. 2090.

11 T. D. 2137.

12 Doyle v. Mitchell Brothers, 247 U. S. 179; U. S. v. Guggenheim Exploration Co., 238 Fed. 231; Forty-Fort Coal Co. v. Kirkendall, 233 Fed. 704.

13 Letter from Treasury Department dated February 26, 1916; I. T. S. 1918, ¶¶ 413 and 1343; Reg. 45, Art. 36.

partment that it will be necessary to ascertain as nearly as possible the true value of the property at the time it was taken over, and any excess over this ascertained value is income. Similarly, it has been ruled that where corporations have acquired for a mere nominal sum, property which at the time of its acquirement had a value greatly in excess of such sum, a careful estimate of the value of the property at the time it was acquired may be fixed and set up as the value representing the cost of the property, and any excess over such fixed value, at which such property may thereafter be disposed of, will be treated as income. The value of property so fixed is subject to the approval of the Internal Revenue Bureau.[14] The Revenue Act of 1918 provides that when property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any,[15] and it seems the "cost" in a subsequent sale by a corporation of property acquired in exchange for its stock would be the equivalent of the "fair market value" of the stock issued therefor.

PROPERTY LEFT BY A DECEDENT. When an individual dies after March 1, 1913, leaving property, all gains or losses on subsequent sales should be computed on the basis of the appraised value of the property at the date of death of the former owner. Neither the executors nor anyone acquiring the property of the decedent is required to make a return of the book gains or losses up to the date of death. If the executors should sell the property the difference between the appraised value at the date of death and the selling price constitutes the taxable profit. If the property is transferred to a beneficiary of the estate no income accrues to the beneficiary as a result thereof, since the value of property acquired by gift, bequest, devise or

14 T. D. 2161. These rulings were made under the 1913 Law, February 19, 1915, and have not been repeated in later compilations.

15 Revenue Act of 1918, § 202 (b). See Page 302.

descent is exempt from tax.[16] Any income which the beneficiary thereafter derives from such property is taxable and, if such property is sold, the difference between the appraised value of the property at the date of decedent's death and the selling price constitutes the taxable profit.[17] In cases where an individual died prior to March 1, 1913, the value on March 1, 1913, of any property left by the decedent is the amount to be used as a basis for computing the taxable profit in any subsequent sale by the executors or the beneficiaries.

Property Acquired Before March 1, 1913. The Revenue Act of 1918 provides that for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1913, shall be the basis for determining the amount of such gain derived or loss sustained.[18] This provision applies in all cases of individuals and corporations. In all such cases the original cost of the property is disregarded and the value as of March 1, 1913, is taken, whether or not such value is more or less than the original cost. Under the 1909 and 1913 Laws it was the practice of the Department to require the taxable profit to be determined by first ascertaining the difference between the cost and the selling price and then pro-rating the result according to the number of months the property was held before and after the incidence of the tax, but this rule has no application under the present laws, except as a last resort when the value as of March 1, 1913, cannot be found by other means.[19]

[16] Revenue Act of 1918, § 213 (b) 3.

[17] Reg. 33 Rev., Art. 4. Telegram from Treasury Department dated February 3, 1917.

[18] Revenue Act of 1918, § 202 (a) 1. This provision first appeared in the 1916 Law, no reference being made in the 1909 Law or the 1913 Law as to assets acquired prior to the incidence of the tax.

[19] In Doyle v. Mitchell, 247 U. S. 179, no question was raised as to whether, in apportioning the profits derived from a distribution of capital assets acquired before and converted after the incidence of

MARKET VALUE OF SECURITIES ON MARCH 1, 1913. Where stock, acquired prior to March 1, 1913, is sold, and such stock was traded in on an exchange, the fair market price or value as of March 1 is held to be the average price for the day in cases where there is a variation between the opening and closing price.[20]

SPECIAL RULE IN CASE OF BOOK VALUES REPORTED UNDER 1909 LAW. Under the provisions of the 1909 Law the Treasury Department permitted income to be computed on the basis of changes in book values. Hence, where a corporation for the years 1909 to 1912 inclusive, made its returns strictly in accord with the regulations then in force, the increase of book values of property being returned as income and corresponding decreases being deducted, as the regulations then required and permitted, the profit on such property could be computed under the 1913 Law by deducting the amount of the last adjusted value subsequent to January 1, 1909, without pro-rating as required in other cases.[21] This ruling has no application under either the 1916 Law, or the Revenue Act of 1918, which expressly requires, in all cases, that the gain be based on the value as of March 1, 1913, regardless of any book values prior thereto.

Selling Price. The selling price is the amount received

the tax, the division should be pro rata according to the time elapsed, or should be based upon an inventory taken as of the day before the incidence of the tax. The latter method was adopted and the government made no contention as to the accuracy of the result thereby reached. In Hays v. Gauley Mountain Coal Co. 247 U. S. 189, the court referred to the method employed as a matter of detail, to be settled according to the best evidence obtainable and in accordance with valid departmental regulations, and in the case at bar, involving a sale of securities, there being no evidence of inventory value, a prorating method was adopted. In U. S. v. Cleveland etc. Railway Co., 247 U. S. 195, the market value of stock on the last day before the incidence of the tax was taken as a measure of capital assets. (See T. D. 2740.)

20 Letter from Treasury Department dated November 21, 1916; I. T. S. 1918, ¶¶ 410 and 1329.

21 T. D. 2130.

for the property. It may be held to be taxable whether received in cash or in the equivalent of cash.[22]

Sale of Patents and Copyrights. A taxpayer disposing of patents or copyrights by sale should determine the profit or loss arising therefrom by computing the difference between the selling price and the value as of March 1, 1913, if acquired prior to that date, or between the selling price and the cost, if acquired subsequently to that date. The profit or loss thus ascertained should be increased or decreased, as the case may be, by the amounts deducted on account of depreciation of such patents or copyrights since February 28, 1913, or since the date of purchase if acquired subsequently to that date.[23]

Sale of Good Will and Trademarks. Any profit or loss resulting from an investment in good will can be taken only when the business, or a part of it, to which the good will attaches is sold, in which case the profit or loss will be determined upon the basis of the cost of the assets, including good will, or their fair market value as of March 1, 1913, if acquired prior thereto. If nothing was paid for good will acquired after February 28, 1913, no deductible loss is possible, although, on the other hand, upon the sale of the business there may be a profit. It is immaterial that good will may never have been carried on the books as an asset, but the burden of proof is on the taxpayer to establish the cost or fair market value on March 1, 1913, of the good will sold.[24]

Sale of Personal Property on the Installment Plan. Dealers in personal property ordinarily sell either for cash, or on the personal credit of the buyer, or on the installment plan. Occasionally a fourth type of sale is met with, in which the buyer makes an initial payment of such a substantial nature (for example, a payment of more than 25 per cent) that the sale, though involving deferred

[22] For a discussion of income in the equivalent of cash see chapter 16 on Income—In General.

[23] Reg. 45, Art. 37.

[24] Reg. 45, Art. 38.

payments, is not one on the installment plan. In sales on personal credit, and in the substantial payment type just mentioned, obligations of purchasers are to be regarded as the equivalent of cash, but a different rule applies to sales on the installment plan. Dealers in personal property who sell on the installment plan usually adopt one of four ways of protecting themselves in case of default: (a) through an agreement that title is to remain in the seller until the buyer has completely performed his part of the transaction; (b) by a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the purchase price; (c) by a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the seller; or (d) by conveyance to a trustee pending performance of the contract and subject to its provisions. The general purpose and effect being the same in all of these plans, it is desirable that a uniformly applicable rule be established. The rule prescribed is that in the sale or contract for sale of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for bears to the gross contract price. If, for any reason, the vendee defaults in his installment payments and the vendor repossesses the property, the entire amount received on installment payments, less the profit already returned, will be income of the vendor for the year in which the property was repossessed. If the vendor chooses as a matter of consistent practice to treat the obligations of purchasers as the equivalent of cash, such a course is permissible.[25]

Sale of Real Estate in Lots. Where a tract of land is purchased with a view to dividing it into lots or parcels of ground to be sold as such, the entire value as of March

[25] Reg. 45, Art. 39.

1, 1913, or cost, if acquired subsequently to that date, shall be equitably apportioned to the several lots or parcels and made a matter of record in the books of the taxpayer, to the end that any gain derived from the sale of any such lots or parcels may be returned as income for the year in which the sale was made. This rule contemplates that there will be a measure of gain or loss in every lot or parcel sold, and does not contemplate that the capital invested in the entire tract shall be extinguished before any taxable income shall be returned. The sale of each lot or parcel will be treated as a separate transaction and the gain or loss will be accounted for accordingly.[26]

Sale of Real Estate Involving Deferred Payments. Deferred payment sales of real estate ordinarily fall into two classes when considered with respect to the terms of sale, as follows:

(1) Installment transactions, in which the initial payment is relatively small (generally less than one-fourth of the purchase price) and the deferred payments usually numerous and of small amount. They include (a) sales where there is immediate transfer of title when a small initial payment is made, the seller being protected by a mortgage or other lien as to deferred payments, and (b) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the agreed installments have been paid.

(2) Deferred payment sales not on the installment plan, in which there is a substantial initial payment (ordinarily not less than one-fourth of the purchase price), deferred payments being secured by a mortgage or other lien. Such sales are distinguished from sales on the installment plan by the substantial character of the initial payment and also usually by a relatively small number of deferred payments.

[26] Reg. 45, Art. 40.

In determining how these classes shall be treated in levying the income tax, the question in each case is whether the income to be reported for taxation shall be based only on amounts actually received in a taxing year, or on the entire consideration made up in part of agreements to pay in the future.[27]

INSTALLMENT TRANSACTIONS IN REAL ESTATE. In the two kinds of transactions included in class (1) in the foregoing article, installment obligations assumed by the buyer are not ordinarily to be regarded as the equivalent of cash, and the vendor may report as his income from such transactions in any year that proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price. If the return is made on this basis and the vendor repossesses the property after default by the buyer, retaining the previous payments, the entire amount of such payments, less the profit previously returned, will be income to the vendor, and will be so returned for the year in which the property was repossessed. If the taxpayer chooses, as a matter of settled practice consistently followed, to treat the obligations of the purchaser as equivalent to cash and to report the profit derived from the entire consideration, cash and deferred payments, as income for the year when the sale is made, this is permissible. If so treated the rule prescribed in the following paragraph will apply.[28]

DEFERRED PAYMENT SALES OF REAL ESTATE NOT ON THE INSTALLMENT PLAN. In class (2) in the next to the last paragraph above the obligations assumed by the buyer are much better secured because of the margin afforded by the substantial first payment, and experience shows that the greater number of such sales are eventually carried out according to their terms. These obligations for deferred payments are therefore to be regarded as equiva-

[27] Reg. 45, Art. 41.
[28] Reg. 45, Art. 42.

lent to cash, and the profit indicated by the entire consideration is taxable income for the year in which the initial payment was made and the obligations assumed. If the buyer defaults and the seller regains title to the land by agreement or process of law, retaining payments previously made, he may deduct from his gross income as a loss such proportion of the defaulted payments as was previously returned as income, provided that so much of the selling price previously received as has not been reported as income is accounted for in the inventory of the property by deduction from the original cost.[29]

[29] Reg. 45, Art. 43.

CHAPTER 21

INCOME FROM RENT

Rent is returnable as income in the year in which it is received, and not necessarily in the year in which it becomes due.[1] Thus, where a tenant pays part of his rent for the preceding year on the second day of January of the following year, the amount so paid is income to the landlord for the year in which it is received, and not the year which it covers.[2] This rule, however, is not absolute, as the landlord may, if he keeps his books accordingly, report the rent for the year in which the income accrues and charge against it the deductions for the same period.

Value of Improvements Made by Tenant. Where, under the terms of a rental or lease contract, a tenant agrees to erect a building or to expend during the rental period a certain fixed sum in making improvements upon the freehold of the lessor, it is held for income tax purposes that the building or permanent improvement becomes a part of the realty unless otherwise agreed between the contracting parties; and, as such, must be accounted for as gain or profit to the lessor at the time the lease is terminated, whether terminated by expiration or otherwise. The amount of the gain or profit to the lessor at the termination of the lease is the difference between the cost of the building or improvement so made by the tenant and a reasonable allowance for depreciation during the period of its life under the lease.[3]

[1] Letter from Treasury Department dated February 26, 1915; I. T. S. 1918, ¶ 353.

[2] Letter from Treasury Department dated February 9, 1915; I. T. S., 1918, ¶¶ 152 and 354.

[3] Reg. 33 Rev., Art. 4; Reg. 45, Art. 45; T. D. 2442. It necessarily

Lessor Corporations. Where a corporation leases all of its property to another and specifies that the consideration therefor shall be paid direct to its stockholders and bondholders or creditors the lessor corporation is, nevertheless, held to be the proper recipient of the income and must report, as rent, the amount so paid to its stockholders, bondholders or creditors by the lessee.[4]

Payments by Tenant on Behalf of Landlord. Where under the terms of a lease a tenant pays taxes, repairs or interest, or makes any other payments for and on behalf of the landlord, the amount of such payments constitutes income to the landlord and should be reported by him as such. The theory covering these transactions is that the tenant is acting merely as agent for the landlord in making such payments. The expenses are the landlord's, which he may deduct from his net income, and the amounts used to defray such expenses must be included by the landlord as his net income.[5] Such payments may be deducted by the tenant as rent in the year in which they are paid.[6]

Receipt of Rent in Kind. Where rent is received in the form of produce, as for instance, a share of the crops of a farm, the amount realized on the sale of such share must be included as income in the year in which the share is disposed of or reduced to money or its equivalent. Where board or lodging is given as the equivalent of rent, the value of such board or lodging is required to be included.[7]

follows that the tenant may consider the cost of the building as a part of his rental payments and may deduct such amount as an expense, pro-rating the original cost over the number of years constituting the term of the lease.

[4] For a further discussion of this subject see sub-heading entitled Lessor and Lessee Corporations in Chapter 12 on Corporations.

[5] Reg. 33 Rev., Art. 4.

[6] Reg. 33 Rev., Art. 8.

[7] See Chapter 16, p. 312.

CHAPTER 22

INCOME FROM INTEREST

Income derived in the form of interest is taxable in the hands of citizens and residents and domestic corporations whether received from debtors in this country or debtors in foreign countries. Interest is taxable in the hands of non-resident aliens and foreign corporations when it is paid on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise.[1]

Interest Exempt from Tax. The Revenue Act of 1918 expressly provides that interest upon the obligations of a state, territory or possession of the United States, and any political subdivision thereof, or the District of Columbia, or securities issued under provisions of the Federal Farm Loan Act of July 17, 1916, or interest upon the obligations of the United States issued prior to September 1, 1917, (and to a limited extent the interest on obligations issued after that date) and bonds issued by the War Finance Corporation, to the extent noted below, shall not be included in gross income, and shall be exempt from income tax.[2]

Interest on Obligations of the United States. Interest received on obligations of the United States, issued on or before September 1, 1917, is not to be included in gross income and is exempt. In the case of obligations issued after that date the interest is exempt only if and to the extent provided in the respective acts, authorizing the issue thereof as amended and supplemented and is

1 Revenue Act 1918, §§ 213 (c) and 233 (b).
2 Revenue Act of 1918, § 213 (b) 4.

excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer both from income (normal and surtax) and profits taxes.[3] Interest credited to postal savings accounts upon moneys deposited in postal savings banks on or before September 1, 1917, is exempt from income tax, while interest credited upon deposits made subsequently to September 1, 1917, is liable to tax. Interest on the bonds of the first liberty loan is entirely exempt from tax, but that absolute exemption is lost if the bonds are converted into bonds of later issues.[4]

Liberty Bond Exemption from Normal Tax. The Second Liberty Bond Act of September 24, 1917, as amended by the Third Liberty Bond Act of April 4, 1918, and by the Fourth Liberty Bond Act of July 9, 1918, provides:

> Sec. 7. That none of the bonds authorized by section one, nor of the certificates authorized by section five, or by section six, of this Act, shall bear the circulation privilege. All such bonds and certificates shall be exempt, both as to principal and interest from all taxation now or hereafter imposed by the United States, any State, or any of the possessions of the United States, or by any local taxing authority, except (a) estate or inheritance taxes, and (b) graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes now or hereafter imposed by the United States, upon the income or profits of individuals, partnerships, associations, or corporations. The interest on an amount

[3] Revenue Act of 1918, §§ 213 (b) 4 and 233. Under earlier income tax laws, interest upon the obligations of the United States was expressly included as taxable income (see Act of March 2, 1867). Under the 1909 Law the Attorney General held that interest on national bonds should be included as income of corporations, since the tax was not on property, but a tax on the privilege of carrying on business (28 Op. Atty. Gen. 138).

[4] Reg. 45, Art. 76.

> of such bonds and certificates the principal of which does not exceed in the aggregate $5,000, owned by any individual, partnership, association, or corporation, shall be exempt from the taxes provided for in subdivision (b) of this section.

Accordingly, all interest on liberty bonds of the second, third and fourth issues is exempt from the normal tax. Such interest may, however, be subject to surtax and may require to be included in gross income. As to any issue after the fourth, the provisions of the act authorizing it will govern its exemption.[5]

Liberty Bond Exemption from Surtax. Section 7 of the Second Liberty Bond Act provides that the interest on an aggregate of not exceeding $5,000 principal amount of liberty bonds of issues after the first, including in such later issues the first liberty bonds converted, owned by any person at one time shall be exempt from all income and war excess profits taxes.[6] The Supplement to Second Liberty Bond Act, approved September 24, 1918, provides:

> That until the expiration of two years after the date of the termination of the war between the United States and the Imperial German Government, as fixed by proclamation of the President—
>
> (1) The interest on an amount of bonds of the Fourth Liberty Loan the principal of which does not exceed $30,000, owned by any individual, part-

[5] Id. Art. 77

[6] Where a husband and wife each own in his own or her own right bonds of these issues not exceeding $5,000, each is entitled to exclude the income therefrom in computing the tax on their joint incomes, and minor children having separate estates are also entitled to the exemption. (Letter from Treasury Department dated October 8, 1917, I. T. S. 1918, ¶ 447.) A taxpayer holding bonds and certificates of indebtedness issued under the act is entitled to the exemption of $5,000 of his aggregate holdings, not on $5,000 of each class of obligations (T. D. 2585).

nership, association, or corporation, shall be exempt from graduated additional income taxes, commonly known as surtaxes, and excess profits and war-profits taxes, now or hereafter imposed by the United States, upon the income or profits of individuals, partnerships, associations, or corporations.

(2) The interest received after January 1, 1918, on an amount of bonds of the First Liberty Loan Converted, dated either November 15, 1917, or May 9, 1918, the Second Liberty Loan, converted and unconverted, and the Third Liberty Loan, the principal of which does not exceed $45,000 in the aggregate, owned by any individual, partnership, association, or corporation, shall be exempt from such taxes: Provided, however, That no owner of such bonds shall be entitled to such exemption in respect to the interest on an aggregate principal amount of such bonds exceeding one and one-half times the principal amount of bonds of the Fourth Liberty Loan originally sub-subscribed for by such owner and still owned by him at the date of his tax return; and

(3) The interest on an amount of bonds, the principal of which does not exceed $30,000, owned by any individual, partnership, association, or corporation, issued upon conversion of 3½ per centum bonds of the First Liberty Loan in the exercise of any privilege arising as a consequence of the issue of bonds of the Fourth Liberty Loan, shall be exempt from such taxes.

The exemptions provided in this section shall be in addition to the exemption provided in Section 7 of the Second Liberty Bond Act in respect to the interest on an amount of bonds and certificates, authorized by such Act and amendments thereto, the principal of which does not exceed in the aggregate $5,000, and in addition to all other exemptions provided in the Second Liberty Bond Act.

Accordingly, there may be excluded from gross income (a) the interest received on not exceeding $5,000 principal amount of liberty bonds of any or all issues after the first, up to and including the fourth; and, until two years after the war, (b) the interest received on not exceeding $30,000 principal amount of liberty bonds of the fourth issue; plus (c) the interest received on an aggregate principal amount of liberty bonds of the first liberty loan, converted, the second liberty loan, converted or unconverted, and the third liberty loan, not exceeding $45,000 and not exceeding 150 per cent of the principal amount of the bonds of the fourth liberty loan both originally subscribed for by the taxpayer and still owned by him at the date of his return; plus (d) the interest received on not exceeding $30,000 principal amount of liberty bonds into which first liberty bonds may have been converted in the exercise of any privilege arising as a consequence of the issue of the fourth liberty bonds.[7] It has been held that an individual who originally subscribed to bonds of the Fourth Liberty Loan to an amount not exceeding $30,000 in accordance with the Government plan and, who made payments in accordance with such plan is not required to pay for such bonds in full on or before December 31, 1918, in order to obtain this exemption. Likewise, if an individual subscribed for bonds of the Fourth Liberty Loan through a bank by agreeing to pay the subscription price in installments acceptable to the bank, and make payments in accordance with this plan, it will not be necessary for such individual to pay for the bonds in full on or before December 31, 1918, in order to obtain this exemption.[8]

Liberty Bond Exemption in the Case of Trusts. (a) When income is taxable to beneficiaries, as in the case of a trust the income of which is to be distributed to the

[7] Id. Art. 78.

[8] Letter from Treasury Department dated January 3, 1919, I. T. S. 1918, ¶ 3715.

beneficiaries periodically, each beneficiary is regarded as the owner of a proportionate part of the bonds held in trust and is entitled to exemption on account of such ownership as if he owned such proportionate part of the bonds directly. In such a case a subscription by a trustee for bonds of the fourth liberty loan constitutes each beneficiary existing at the time of such subscription an original subscriber for his proportionate part of such bonds and entitles such beneficiary to the collateral exemption of interest on bonds of previous issues, whether owned by such beneficiary or by the trustee, as if the beneficiary had himself originally subscribed for such proportionate part of the bonds, and a subscription by such beneficiary for bonds of the fourth liberty loan entitles him to the collateral exemption of interest on bonds of previous issues held by the trustee. (b) When, on the other hand, income is taxable to the trustee, as in the case of a trust the income of which is accumulated for the benefit of unborn or unascertained persons, the trustee is regarded as the owner of all the bonds held in trust and the trust is entitled to any exemption on account of such ownership. In such a case a subscription by a trustee constitutes the trustee as such the original subscriber and entitles the trust, on account of such subscription, to the collateral exemption of interest on bonds of previous issues.[9]

Liberty Bond Exemption in the Case of Partnerships and Personal-Service Corporations. As income of a partnership is taxable to the individual partners, each partner is treated and entitled to exemption on account of such ownership as if such partner owned such proportionate part of the bonds directly. Such partner, if a partner at the time of the original subscription by the partnership for bonds of the fourth liberty loan, is treated as an original subscriber for a proportionate part of such bonds subscribed for by the partnership and is en-

[9] Reg. 45, Art. 79.

titled to the collateral exemption of interest on bonds of previous issues on account of such original subscription for bonds of the fourth liberty loan as if he had subscribed directly for such proportionate part of the bonds. This principle applies also to stockholders in personal-service corporations.[10]

War Finance Corporation Bonds. The War Finance Corporation Act makes the same provision for the exemption of bonds which the War Finance Corporation is empowered and authorized to issue, as is provided in the case of Second Liberty Loan Bonds as to interest on an amount of such bonds, the principal of which does not exceed in the aggregate $5,000 owned by any individual, partnership, corporation or association.[11]

Interest from Federal Land Bank and National Farm Loan Association. As section 26 of the Federal Farm Loan Act of July 17, 1916, provides that every federal land bank and every national farm loan association, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate, and that farm loan bonds, with the income therefrom, shall be exempt from taxation, the income derived from dividends on stock of federal land banks and national farm loan associations and from interest on such farm loan bonds is not subject to the income tax.[12]

Obligations of the Possessions of the United States. Interest paid on the obligations of possessions of the United States is exempt.[13]

Obligations of the Territories. Interest on the obligations of the Territories, or political subdivisions thereof, is exempt.[14]

10 Id. Art. 80.

11 Act of April 5, 1918 (Public No. 121), § 16.

12 Reg. 45, Art. 74.

13 Revenue Act of 1918, § 213 (b) 4.

14 Such interest was not exempt under the 1916 law, since the law

Obligations of the District of Columbia. Interest upon obligations of the District of Columbia is now exempt; such interest was not expressly included in the exemption provision of the 1916 law.[15]

Interest on the Obligations of a State. The same principle which denies to a state power to raise revenue by taxation on federal property, or sources of revenue, or means of carrying on its duties, forbids taxation of state revenue for federal purposes.[16] Therefore the United States has no power under the Constitution to tax either the instrumentalities or the property of a state.[17] A municipal corporation is a portion of the sovereign power of a state and is not subject to taxation by Congress upon its municipal revenue.[18] But the exemption of state agencies does not extend to those used by the state in carrying on an ordinary private business.[19] Interest on the obligations of a state is, therefore, expressly exempt. The 1909 Law, however, being an excise tax and not an income tax, was valid although measured by income which included interest from state securities.[20]

POLITICAL SUBDIVISION OF A STATE. A political subdivision is any division of a State or Territory made by the proper authorities thereof acting within their constitutional powers for the purpose of carrying out a portion of those functions of the State or Territory which by long usage and the inherent necessities of government have always been regarded as public. The Attorney General has held that special assessment districts created for a public purpose, such as the improvement of streets and

did not expressly include territories in the exemption provision. (Revenue Act of 1916, § 4.)

15 Compare Revenue Act of 1918, § 213 (b) 4 and Revenue Act of 1916, § 4.

16 Collector v. Day, 11 Wall. 113; Dobbins v. Erie Co., 16 Pet. 435; Ambrosini v. U. S., 187 U. S. 1.

17 Pollock v. Trust Company, 157 U. S. 429, 584.

18 U. S. v. B. & O. Railroad Company, 17 Wall. 322.

19 South Carolina v. U. S., 199 U. S. 437.

20 Flint v. Stone Tracy Co., 220 U. S. 107.

public highways, the provision of sewage, gas and light and the reclamation, drainage, or irrigation of land are districts for public use, and consequently political subdivisions of the state, within the meaning of the law.[21] Road, water, school, levee, harbor and port improvement districts lawfully created and authorized by the State to levy a tax to meet the obligations of such district are also held to be political subdivisions of the state.[22] However, a district without power to exercise any governmental function, created for the purpose of making some improvement, primarily beneficial to the property located in and comprising the district, is not, within the meaning of these acts, a political subdivision of the State. Obligations issued in payment for such improvement, although guaranteed by a county, municipality, or other political subdivision of the State, are not the obligations of the State or of any political subdivision thereof; but are rather the obligations of the benefited property upon which they constitute a lien. Hence, the income derived from obligations which are a direct charge against or lien upon benefited property is not exempt and must be returned as income of the recipient.[23]

MORTGAGE ASSUMED BY MUNICIPALITY. Although interest on municipal bonds is exempt from the tax, yet where a municipality has purchased a public utility subject to a mortgage, and the mortgage retains its original charac-

[21] Opinion of Attorney General dated January 30, 1914. In the course of his opinion the Attorney General said: "* * * where the power to levy a tax is given a district by the state, presumptively that district is created for a public use, and is exercising a public function. * * * Nor does it make any difference that the tax is measured by the benefit conferred." But he refrained from expressing any opinion whether assessment districts might not be created for a purely private purpose so as to bring them within the principles laid down in the South Carolina Dispensary case, 199 U. S. 437, rather than within those which governed U. S. v. B. & O. Railroad Company, 17 Wall. 322.

[22] T. D. 1946; Reg. 45, Art. 73.

[23] Reg. 33 Rev., Art. 84.

ter, even though the municipality assumes the mortgage indebtedness and pays the interest thereon, the mortgage does not become an obligation of the municipality within the meaning of the law and the interest thereon is not exempt.[24]

Excluding Exempt Interest from Gross Income. It is provided in the respective acts authorizing the issue of Second, Third and Fourth Liberty Bonds, and the War Finance Corporation Bonds, all of which were issued after September 1, 1917, that interest upon such bonds shall be exempt from the normal tax.[25] As indicated in the foregoing paragraphs, the extent of exemption of the interest upon such bonds from surtax and war-profits and excess-profits taxes depends upon the amount of principal of such bonds owned by the taxpayer. The Revenue Act of 1918 provides[26] that in the case of obligations of the United States issued after September 1, 1917, and in the case of bonds issued by the War Finance Corporation the interest shall be exempt only if and to the extent provided in the respective acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer both under the income and war excess-profits taxes. Conversely, only interest from Second, Third and Fourth Liberty Bonds and Bonds issued by the War Finance Corporation which is not wholly exempt from normal tax, surtax and profits taxes need be included in gross income. Income from United States obligations issued prior to September 1, 1917, interest on bonds of states, territories, possessions of the United States (and political subdivisions thereof) and the District of Columbia, need not be included in gross

[24] T. D. 2090.

[25] Act of September 24, 1917 (Public No. 43); Act of April 4, 1918 (Public No. 192); Act of April 5, 1918 (Public No. 121); Act of July 9, 1918 (Public No. 192); Act of September 24, 1918 (Public No. 217).

[26] Revenue Act of 1918, § 213 (a) 4.

income, but the amount of such securities owned by the taxpayer and the income therefrom must be stated in his return.[27]

Interest on Bonds of Exempt Organizations. Although a corporation may be exempt[28] from a tax on its income, yet interest on the bonds of such an organization is taxable income to the bondholder.[29]

Accrued Interest on Obligations at Time of Purchase. Where a purchaser pays the price of the security purchased and an additional sum representing accrued interest, the amount of interest received on the next interest date should not be reported in full. The amount of accrued interest at the time of purchase represents the return of capital to the purchaser and he should deduct such amount from the interest received, and report the remainder only. The seller of the security should account in his return for the accrued interest received at the time of sale, since to him that amount is income.[30]

Interest on Bank Deposits. Interest on bank deposits or on certificates of deposit, credited to the account of the depositor by the bank, is income for the year in which the credit is made.[31]

Interest Received and Paid by Brokers. Where the customers of a brokerage house buy securities, paying only a part of the purchase price and paying interest on the balance, and the brokerage house buys such securities

[27] Revenue Act of 1918, § 213 (a) 4.

[28] Revenue Act of 1918, § 231.

[29] Letter from Treasury Department dated July 30, 1914; I. T. S. 1918, ¶ 1319.

[30] Reg. 33 Rev., Art. 4; Letter from Treasury Department dated February 5, 1915; I. T. S. 1918, ¶ 360. In a later ruling the Treasury Department declined to permit the taxpayer in such a case to report all of the interest received as income and to deduct the amount of accrued interest paid at the time of purchase as an expense or as interest paid by the purchaser. Letter dated March 8, 1915, I. T. S. 1917, ¶ 237.

[31] Reg. 33, Art. 67; Letter from Treasury Department dated February 18, 1915; I. T. S. 1918, ¶ 363.

from others, paying only a part of the purchase price and paying interest on the balance, the brokerage house must include in its return as gross income the interest received from the customers and may deduct as interest the amount of interest it pays on such purchases.[32]

Interest Accruing Prior to March 1, 1913. Where interest became due prior to March 1, 1913, and funds have been on hand to pay the same since the due date the amount is not taxable, since it represents income that was due and payable and could have been reduced to possession on demand prior to the incidence of the income tax. Even where interest has been in default since a time prior to March 1, 1913, and funds to pay the same have accrued since that date, it has been held that the interest represents income accrued to the owners of the bonds prior to the incidence of the tax, and hence does not constitute taxable income when received thereafter.[33]

[32] Altheimer Rawlings Investment Co. v. Allen, 248 Fed. 688, petition for writ of certiorari to United States Supreme Court denied November 11, 1918; see T. D. 2686 and T. D. 2441. This case was decided under the 1909 Law, but the principle seems to apply to the language of the present law. Interest would be deducted in full if paid on collateral the subject of sale in the ordinary course of business. The amount of such interest deductible in the case of corporations was limited under the 1916 Law. See Chapter 12 on corporations.

[33] Letter from Collector at Cincinnati dated March 16, 1915, embodying decision of the Treasury Department; I. T. S. 1918, ¶¶ 463 and 823.

CHAPTER 23

INCOME FROM DIVIDENDS

The law expressly states that the gross income of a taxpayer shall include gains, profits and income derived from dividends.[1]

Definition. The term "dividend," as used in the Revenue Act of 1918 (with one exception where it is used in connection with dividends paid by insurance companies on policy and annuity contracts) is defined therein to mean (1) any distribution made by a corporation, other than a personal-service corporation, to its shareholders or members, whether in cash or in other property or in stock of the corporation, out of its earnings or profits accumulated since February 28, 1913, or (2) any such distribution made by a personal-service corporation out of its earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.[2] Amounts distributed in the liquidation of a corporation are expressly required to be treated as payments in exchange for stock or shares, and any gain or profits realized thereby will be taxed to the distributee

1 Revenue Act of 1918, §§ 213 (a) and 234 (a) 10. The Revenue Act of 1916 provided that subject only to such exemptions and deductions as were thereinafter allowed, the *net* income of a taxpayer should include gains, profits and income derived from dividends (Revenue Act of 1916, § 2 (a).).

2 Revenue Act of 1918, § 201 (a). It will be noted that the new definition, aside from its provision for personal-service corporation distributions, omits the words "or ordered to be made"; substitutes the word "accumulated" for "accrued"; and also expressly includes distributions made "in other property." See Revenue Act of 1916, § 31 (a), Reg. 33 Rev., Art. 106.

as other gains or profits.[3] It is to be noted that under this definition any distribution other than a distribution in liquidation which is made by a corporation of earnings or profits accumulated snce February 28, 1913, is a dividend; it need not necessarily be called a dividend. On the other hand, if the distribution is not out of earnings or profits accumulated since February 28, 1913 (and prior to January 1, 1918, in the case of personal-service corporations), it does not become a dividend within the meaning of the law by reason of the fact that it is called a dividend by the corporation making the distribution. The term "corporation," as used in this chapter, includes associations, joint-stock companies, and insurance companies.[4] The term "taxpayer," unless otherwise indicated, includes any person, trust, or estate subject to the tax, and the term "person" includes individuals, partnerships and corporations.[5] The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income of the taxpayer is computed;[6] and the term "personal-service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor, but does not include any foreign corporation nor any corporation fifty per centum or more of whose gross income consists either (1) of gains, profits or income derived from trading as a principal, or (2) gains, profits, commissions or other income derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.[7] The term "foreign corporation" means a

[3] Revenue Act of 1918, § 201 (c).
[4] Revenue Act of 1918, § 1.
[5] Revenue Act of 1918, § 1.
[6] Revenue Act of 1918, § 200.
[7] Revenue Act of 1918, § 200.

corporation created or organized outside the United States.[8] The term "non-resident foreign corporation" means a foreign corporation which is not engaged in trade or business within the United States and has no office or place of business in this country, and a "resident foreign corporation" is a corporation which is engaged in trade or business in this country, or has an office or place of business in the United States.[9]

DIVIDENDS ON LIFE INSURANCE POLICIES. It is a custom of insurance companies to return each year a portion of the premium paid by the insured. The amount so returned is usually designated as a "dividend" and is either received in cash by the insured or applied by him to the reduction of the next annual premium. The law expressly provides that amounts received as a return of premiums paid by the taxpayer is not income.[10] Where, however, dividends are received on a paid-up policy the amount must be included and should be considered the same as dividends from corporations,[11] unless, of course, the dividend was not paid by the insurance company out of earnings or profits accrued since the incidence of the tax.

DIVIDENDS FROM ASSOCIATIONS. Since associations, joint-stock companies and insurance companies (whether incorporated or not) are treated as corporations and limited partnerships may be so treated,[12] the net earnings of such organizations should be considered as dividends.[13] Thus under the 1916 Law and former laws private banks, which had the form of corporate organization, were required to make returns as corporations, and the owners of the bank were authorized to treat as dividends the earnings which they received therefrom.[14] The recipi-

[8] Revenue Act of 1918, § 1.

[9] See Chapter 14 on Foreign Corporations.

[10] Revenue Act of 1918, § 213 (a) 2.

[11] T. D. 2137.

[12] See the discussion of limited partnerships in Chapter 10 on Partnerships.

[13] T. D. 2152.

[14] T. D. 2137.

ent of profits of associations or limited partnerships should, therefore, ascertain whether the association or partnership is paying the tax as a corporation and in such event should treat the net profits of the association as dividends.

DIVIDENDS FROM CO-OPERATIVE MERCHANDISING ORGANIZATIONS. Dividends paid by co-operative merchandising organizations in the nature of a periodical refund to members or prospective members or patrons generally in proportion to the purchases made by the recipient were held under the 1916 Law to be wholly different from ordinary dividends based on stock-holdings, and were not required to be listed as income by the recipient.[15]

Extent to Which Dividends Are Taxable. The extent to which a dividend is taxable depends upon the status of the corporation paying the same and upon the status of the recipient of the dividend.[16] As a general rule, income from dividends is only subject to the surtaxes, and, except in the case of certain stock dividends, is taxable at the rates in force in the year received.

DIVIDENDS PAID BY DOMESTIC CORPORATIONS. In the case of dividends declared and paid by a domestic corporation which is liable to income tax upon its net income or by a personal-service corporation out of earnings and profits upon which income tax has been imposed, the dividend is not subject to the normal tax if received by an individual, the amount of the same being expressly allowed as a credit for the purpose of the normal tax.[17] If the individual is a non-resident alien the credit of such dividends for purposes of the normal tax will be allowed only in case he files a true and accurate return of his total income received from all sources, corporate or otherwise in the United States, in the manner prescribed by law.[18] If such a dividend is received by a corporation, domestic

[15] T. D. 2737. See Chapter 15 on Exempt Organizations.

[16] Revenue Act of 1918, § 201 (d).

[17] Revenue Act of 1918, § 216 (a).

[18] Revenue Act of 1918, § 217.

or foreign, the amount thereof is allowed as a deduction from the taxable income of the corporation receiving the same.[19]

DIVIDENDS PAID BY PERSONAL-SERVICE CORPORATIONS. In the case of dividends declared and paid by personal-service corporations out of earnings or profits upon which income tax has been imposed,—that is, earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918,—the above mentioned rules apply.[20]

DIVIDENDS PAID BY NON-RESIDENT FOREIGN CORPORATIONS. Dividends paid by a non-resident foreign corporation deriving no income from this country if paid out of its earnings or profits accumulated since February 28, 1913, are taxable when received by a citizen or resident of this country and must be reported for the purpose of both the normal and the surtaxes. When received by a domestic corporation such dividends are subject to income and excess-profits taxes. When received by non-resident aliens or foreign corporations they are subject to no tax, although they may be paid by the paying agent for the paying corporation at a place within the United States.

DIVIDENDS PAID BY RESIDENT FOREIGN CORPORATIONS. When a foreign corporation derives its entire income from business done wholly within the United States, and pays the income tax upon its entire net income, dividends declared by it should be treated in the same manner as dividends from domestic corporations.[21] If a foreign corporation pays the income tax on a part of its net income, the dividends it pays should be treated, to that extent, as

19 Revenue Act of 1918, § 234 (a) 6 and (b). Under the 1913 Law corporations were not permitted to deduct the amount received as dividends from other corporations subject to the income tax. This was likewise true of the 2% tax imposed by the 1916 Law, but for the purpose of the 4% tax imposed by the 1917 Law the amount of such dividends was permitted as a credit. (Revenue Act of 1917, § 3; Reg. 33 Rev., Art. 105.)

20 See Revenue Act of 1918, §§ 216 (a), 234 (a) 6, and 217.

21 Revenue Act of 1918, §§ 216 (a) and 234 (a) 6. See T. D. 2090.

dividends of domestic corporations are treated. Thus, if a foreign corporation pays the income tax on half of its income, half of the amount of its dividends should be credited for purposes of the normal tax when paid to individuals, and deducted when paid to corporations.[22]

DIVIDENDS RECEIVED BY CITIZENS AND RESIDENTS. When dividends are received by individuals who are citizens or residents of this country, they must be included in the return of income; but for the purpose of assessing the normal tax, the amount of dividends received from the net earnings of any corporation taxable upon its net income, or from a personal-service corporation, out of earnings or profits upon which income tax has been imposed, may, as indicated in the foregoing paragraphs, be taken as a credit. For the purpose of assessing the surtaxes no credit or deduction for such dividends will be allowed. The same rule applies where dividends are received by the estate of a deceased citizen or resident or by a trust estate created by a citizen or resident. The fact that an individual may not have legal title to the stock on which the dividends are declared does not alter the rule, if he is the actual beneficial owner. Therefore, the amount which may be received by a trustee in the form of dividends may be treated as dividends by the beneficiary in making his return; and similarly dividends received by a partnership are treated as dividends received by the partners, when the partners make their personal returns of their net distributive shares in the profits of the partnership.[23]

DIVIDENDS RECEIVED BY NON-RESIDENT ALIENS. A non-resident alien is subject to the normal tax on dividends of corporations taxable upon their net income, or personal-service corporations out of earnings or profits upon which income tax has been imposed, unless he files or causes to

22 So ruled for purpose of excess profits tax in 1917. See Reg. 41, Art. 27.

23 T. D. 2090; Revenue Act of 1918; §§ 218 and 219. See U. S. v. Coulby, 251 Fed. 982.

be filed a true and accurate return of his total income from all sources, corporate or otherwise, in the United States, in the manner prescribed for non-resident aliens. By so doing he is entitled to claim credit for the purpose of the normal tax on the amount of such dividends.[24] Although this credit for the purpose of the normal tax may be enjoyed by a non-resident alien only by filing a return of income received from all sources corporate or otherwise within the United States, the normal tax is, nevertheless, not deducted at the source upon payments of dividends to non-resident aliens, since the section of the law providing for deduction at the source expressly declares that it shall not apply to income received as dividends from a corporation which is taxable upon its net income.[25] Dividends received by a non-resident alien from the net earnings of foreign corporations are not income from sources within this country, even though the dividend is paid in this country.

DIVIDENDS RECEIVED BY CORPORATIONS. Although a corporation must include in its gross income all dividends on the stock of corporations of which it may be a stockholder, it is entitled under the Revenue Act of 1918 to deduct amounts received as dividends from corporations taxable upon their net income, and amounts received as dividends from personal-service corporations out of earnings or profits upon which income tax has been imposed,[26] Under the 1913 and 1916 Laws dividends were taxable income to corporations. Under the 1917 War Income Tax Law and the present law dividends are not taxable income.

DIVIDENDS RECEIVED BY NOMINAL STOCKHOLDERS. Under the 1916 Law, when a dividend was received by one who was not the actual owner of the stock, but was the

[24] Revenue Act of 1918, § 217. See Revenue Act of 1916, § 6 (c), as amended by Revenue Act of 1917.

[25] Revenue Act of 1918, § 221 (a). See Revenue Act of 1916, § 9 (b), as amended by Revenue Act of 1917. Letter from Treasury Department dated June 4, 1918; I. T. S. 1918, ¶ 3452.

[26] Revenue Act of 1918, § 234 (a) 6.

owner of record, he was not required to include the amount thereof in his own income tax return,[27] but proceeded in accordance with rules stated elsewhere in this book.[28]

DIVIDENDS ON STOCK OF FEDERAL RESERVE BANKS AND LAND BANKS. Dividends or income derived from the stock of Federal Reserve Banks is exempt from the tax on the theory that the exemption provided for in the Federal Reserve Act attaches to and follows the dividends into the hands of the member banks holding the Federal Reserve Bank stock.[29] But this theory does not operate to exempt the dividends of member banks in the hands of their stockholders.[30] Dividends on stock of federal land banks and national farm loan associations are exempt by the provisions of the Federal Farm Loan Act.

Dividends from Profits or Surplus of Prior Years. Under the 1916 Law, as amended, the rate of tax on dividends received in 1917 depended upon the year in which the amount distributed as dividends was earned by the paying corporation. The law provided expressly that the dividends should be a part of the annual income of the distributee for the year in which received, but should be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation.[31] The Revenue Act of 1918 provides "that if any *stock* dividend (1) is received by a taxpayer between January 1, and November 1, 1918, both dates inclusive, or (2) is during such period *bona fide* authorized or declared, and entered on the books of the corporation, and is received by a taxpayer after November 1, 1918, and before the expiration of thirty days after the passage of this act, then such dividend shall in the manner provided in Section 206, be

27 Letter from Treasury Department dated November 21, 1916; I. T. S. 1918, ¶ 272.

28 See Chapter 7.

29 Reg. 45, Art. 75; Federal Reserve Bulletin, April 1, 1916.

30 Reg. 33 Rev., Art. 86.

31 Revenue Act of 1916, § 31 added by Revenue Act of 1917.

taxed to the recipient at the rates prescribed by law for the years in which the corporation accumulated the earnings or profits from which such dividend was paid, but the dividend shall be deemed to have been paid from the most recently accumulated earnings or profits.''[32] All other dividends are taxable under the present law at the rates prescribed by law for the years in which they are received by the distributee.[33] The Revenue Act of 1918 also provides that ''any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period.''[34] It seems clear that this provision applies only to stock dividends declared and paid within the periods stated above, as it is only in such cases that the law authorizes the tax to be computed at the rates in force in the years the earnings or profits were accumulated. The rulings and regulations issued pursuant to the provision added to the 1916 Law by the 1917 Law, in regard to the taxation of dividends at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation are set forth in this paragraph, but their application is now limited to cases arising under the 1916 Law, in 1917, and stock dividends as indicated above under the present law, and is modified by the provision that any distribution made during the first sixty days of any taxable year shall be deemed to

32 Revenue Act of 1918, § 201 (d).
33 Reg. 45, Art. 1641.
34 Revenue Act of 1918, § 201 (e).

have been made from earnings or profits accumulated during preceding taxable years. When an individual receives dividends declared from surplus of prior years, he will be required to add it to his other income for the current year as indicated by the following illustration: Assume, for instance, that an individual is in receipt of $20,000 of income for the year 1917 and also received in 1917 $10,000 from dividends out of surplus and undivided profits accumulated by the paying corporation in 1916. The individual recipient will add the $10,000 received in the form of such dividends to the $20,000 received from other sources and will pay the surtax at the 1916 rates on the amount between $20,000 and $30,000. If he should also have received dividends from surplus and undivided profits accumulated in 1915, 1914 and 1913 he will add the sum of such dividends to the total of $30,000 and pay tax at the rates prescribed by the 1913 Law, on the amount by which the total exceeds $30,000.[35] While the above provision of the Revenue Act of 1918, read literally, would seem to tax stock dividends to a recipient corporation at the rate prescribed by law for the years in which the paying corporation accumulated the earnings or profits from which such dividends were paid—thus, for example, taxing dividends out of earnings or profits accumulated in 1917 at the rate of 2%—the provision must be read in connection with the section,[36] allowing the deduction of dividends when received by a corporation. It is a well known principle of statutory interpretation that effect should be given, if possible, to the entire statute and one part should not be allowed to defeat another part, if by any reasonable construction the two can stand together,[37] and also that, in cases of conflict, special provisions take precedence over general provisions. The construction above indicated would defeat the more special provision

[35] See instructions on Form 1040 Revised, (1917) Page 2, Schedule F.

[36] Revenue Act of 1918, § 234 (a) 6.

[37] U. S. v. Ninety-nine Diamonds, 139 Fed. 961.

for the deduction of dividends when received by a corporation, and it seems more reasonable to conclude that stock dividends will in no event be taxed to a recipient corporation in spite of the definition of word the "taxpayer" contained in the Revenue Act of 1918.[38] This construction restricts the operation of the provision to the surtax applicable to individuals; in other words, the effect of the provision seems to be that any stock dividend received by a tax-payer during the calendar year 1918 will be taxed, *only if it is taxable,* to the recipient at the rates prescribed by law for the years in which the corporation accumulated the earnings or profits from which such dividend was paid, the emphasis of the provision being on the words "at the rates" rather than the words "shall be taxed."[39] A corporation declaring and paying stock dividends out of earnings or profits accumulated over a period of years, should make a record in its books of the amount of such dividends paid out of each year's profits or earnings and advise the stockholders accordingly, in order that such dividends received by them may be taxed at the respective rates prevailing during the years in which the profits or earnings so distributed were earned.[40] Dividends of foreign corporations received by citizens or residents of the United States were to be apportioned to prior years, in the same manner as the dividends of domestic corporations.[41]

Dividends Deemed to Be from Most Recently Accumulated Earnings or Profits. The 1916 Law, as amended by the 1917 Law, expressly provided that any distribution

[38] See Revenue Act of 1918, § 1.

[39] Under the 1916 Law when such dividends were received by a corporation, the computation was more simple, as there was no graduated tax to be taken into consideration. Thus, a corporation receiving $30,000 in dividends in 1917, $10,000 of which was from surplus earned in each of the years 1914, 1915 and 1916, would pay 1% on $20,000 (the rate for 1914 and 1915) and 2% on $10,000 (the rate for 1916).

[40] Reg. 33 Rev., Art. 107.

[41] Letter from Treasury Department dated March 14, 1918; I.

made to stockholders in 1917, or thereafter, should be deemed to have been made from the most recently accumulated undivided profits or surplus.[42] The Revenue Act of 1918 provides that certain *stock* dividends are deemed to have been paid from the most recently accumulated earnings or profits.[43] The rulings and regulations issued pursuant to the above provision added to the 1916 Law by the 1917 Law that any distribution shall be deemed to have been made from the most recently accumulated undivided profits or surplus are set forth in the following paragraphs but their application is now limited to the stock dividends specified in the present law.[44] The provision of the 1916 Law was held to have reference to the profits and surplus in existence at the time of the payment of the dividend, and not the time of declaration. In other words, the term "distribution" as used in the law, was held by the Treasury Department to mean the payment and not the declaration of dividends.[45] If a corporation distributed dividends in 1917, such dividends were deemed to have been paid

T. S. 1918, ¶ 3209 reversing telegram from Treasury Department, dated January 30, 1918; I. T. S. 1918, ¶ 3073.

42 Revenue Act of 1916, § 31 (b) added by Revenue Act of 1917; Letter from Treasury Department dated February 9, 1918; I. T. S. 1918, ¶ 3099. Under the 1916 Law, the Treasury Department ruled that dividends could be declared from any specified fund, that is, a dividend could be declared from surplus accumulated prior to March 1, 1913, and consequently be free from tax in the hands of the stockholders, although the corporation had surplus and undivided profits accumulated since that date sufficient to pay the dividend. This ruling is annulled by the amendment of October 3, 1917, except as indicated in the text.

43 Revenue Act of 1918, § 201 (d).

44 See the discussion in a later paragraph of this chapter upon the constitutional question of taxing stock dividends.

45 The provision did not apply to any distribution made prior to August 6, 1917, out of earnings or profits accrued prior to March 1, 1913. The Treasury Department held that if a dividend was declared prior to August 6, 1917, out of earnings or profits accrued prior to March 1, 1913, such dividend would be deemed to be from the most recently accumulated profits or surplus unless the dividend was also paid prior to August 6, 1917. Letter from Treasury De-

from the earnings of 1917, and the recipient, if an individual, was liable to surtax, if any, at the rates for the year 1917, unless it was shown to the satisfaction of the Commissioner of Internal Revenue that at the time such dividends were paid, the earnings up to that time were not sufficient to cover the distribution, in which case the excess over the earnings of the taxable year were deemed to have been paid from the most recently accumulated surplus of prior years, and were taxed at the rate or rates for the year or years in which earned.[46] The language used in the 1916 Law was that the dividends "shall be deemed to have been declared from the most recently accumulated undivided profits or surplus," regardless of what the actual facts might be. Thus, the corporation might actually intend to make a distribution in the form of dividends out of some fund other than the most recently accumulated profits or surplus, but, nevertheless, the law deemed such payment to have been made from the most recently accumulated profits and surplus and the dividend was taxable on that basis. This was true even though such profits were invested in obligations of the United States issued after September 1, 1917, as the investment of earnings did not prevent them from being distributed as dividends.[47] It was immaterial what disposition had been made of the funds earned in the taxable year;[48] the net income as disclosed by the books as having accrued up to the date on which the dividends were paid was deemed to be distributed thereby.[49] In view of the difficulties

partment dated February 9, 1918; I. T. S. 1918 ¶ 3099; telegram from Treasury Department dated January 31, 1918; I. T. S. 1918, ¶ 3069; telegram from Treasury Department dated July 5, 1918; I. T. S. 1918 ¶ 3592.

[46] Reg. 33 Rev., Art. 107. Letter from Treasury Department dated February 9, 1918; I. T. S. 1918, ¶ 3099; telegram from Treasury Department dated February 14, 1918; I. T. S. 1918, ¶ 3104.

[47] Letter from Treasury Department dated May 27, 1918; I. T. S. 1918, ¶ 3448.

[48] Id.

[49] T. D. 2659.

which many corporations had in determining whether earnings in 1917 up to the date of dividend payment in that year were sufficient to cover the dividend paid, corporations were permitted to distribute the earnings for the accounting period for which the dividend in question was paid ratably over the period for the purpose of determining the amount of earnings during the period up to the date of payment.[50] In determining the source of earnings from which a particular distribution was made, a corporation was permitted to treat the undivided profits and surplus of the current year as reduced by payments for income and excess profits taxes, or if keeping its accounts upon an accrual basis by proper reserves for such taxes, although such payments or reserves were not deductible in computing the income of the corporation for income and excess profits taxes.[51]

Dividends from Earnings or Profits Accumulated Prior to March 1, 1913. Any distribution will be deemed to have been made from earnings or profits unless all earnings and profits have first been distributed. Any distribution made in the year 1918 or any year thereafter will be deemed to have been made from earnings or profits accumulated since February 28, 1913, but any surplus accumulated prior to March 1, 1913, may be distributed in stock dividends or otherwise, exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.[52]

[50] T. D. 2678.

[51] T. D. 2700; T. D. 2736; Letter from Treasury Department dated May 13, 1918; I. T. S., 1918, ¶ 3377.

[52] Revenue Act of 1918, § 201 (b). Compare with Revenue Act of 1916, Section 31, added by Revenue Act of 1917. The conflict in the cases in the lower federal courts under the 1913 Law, as to the taxability of dividends distributed subsequent to the incidence of the tax from earnings which accrued prior thereto (the law itself being silent on that point), has now been settled. In Lynch v. Turrish, 236 Fed. 653, it was held that a sum received by a stockholder in excess of the par value of his stock, exclusively from the increase

SUCH DIVIDENDS EXEMPT ONLY TO STOCKHOLDERS OF FIRST CORPORATION. Under the 1916 Law it was held that where dividends had been paid from surplus accrued prior to March 1, 1913, they were free from tax in the hands of the stockholder, but if such stockholder was a corporation, upon the distribution to its stockholders of the sum so received as dividends, the fund became taxable to the stockholders of the second corporation as, to the holding

in value of his stock prior to March 1, 1913, on account of the gradual advance of the value of the property of the corporation prior to that date, was not income when distributed by the corporation after the incidence of the tax. This decision was affirmed by the United States Supreme Court (247 U. S. 221). In Lynch v. Hornby, 236 Fed. 661, decided at the same time, the same lower court held that dividends received by a stockholder by the conversion of property into money and the distribution after the incidence of the tax, was not taxable where the dividend represented the value of property owned by the corporation on March 1, 1913, including the increase of the value of its timber lands and *surplus from its business operations*, the Court announcing that, in its opinion, no property held by the corporation or the stockholder whether original capital or previously earned surplus income, gains or profits, was intended to be made, or was made, taxable as income by the 1913 Law, so far as it represented the value of such property on March 1, 1913. The Supreme Court reversed this decision, 247 U. S. 339, distinguishing the case from the situation in Lynch v. Turrish on the ground that the dividends to Hornby were not single and final, and did not represent the winding up or liquidation of the entire assets and business of the company, and a return to him of the value of his stock upon his surrender of his entire interest, and on the ground that Congress drew a distinction between a stockholder's undivided share or interest in the gains and profits of the corporation prior to the declaration of a dividend, and his participation in the dividends declared and paid; the Court proceeding on the theory that the stockholder is in the ordinary case a different entity from a corporation and that Congress was at liberty to treat dividends coming to him as constituting a part of his income when they came to hand, even though they might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing. The court distinctly held that under the 1913 Law dividends declared and paid in the ordinary course by a corporation to its stockholders after March 1, 1913, *whether from current earnings or from a surplus accumulated prior to that date*, were taxable as income to the stock-

company, such sum did not represent earnings or profits accrued prior to March 1, 1913. While the law provided for the exemption of dividends from corporate funds earned prior to March 1, 1913, it was held it did not provide for tracing the identity or character of such dividends after the receipt thereof by the stockholders of the corporation which earned the fund prior to the incidence of the tax.[53] Under the present law the dividends received by a corporation are not taxed in any event.

DIVIDENDS RECEIVED BY AN ESTATE. Dividends received by an estate are not exempt because paid from surplus accrued prior to the creation of the estate, but are taxable as are dividends received by other taxpayers, that is, either to the beneficiaries if the income is distributed, or to the estate if it is not distributed,[54] unless the dividends were paid from earnings or profits which accrued to the corporation prior to March 1, 1913.

Dividends from Exempt Income. Interest on State, municipal and United States bonds received by corpora-

holder. See Skinner v. Union Pacific Coal Co., 249 Fed. 152. The case of Peabody v. Eisner 247 U. S. 347, followed Lynch v. Hornby in principle. In Southern Pacific Co. v. Lowe, 238 Fed. 847, the district court held that dividends from surplus accumulated prior to March 1, 1913, were not taxable if the surplus represented an increase in the value of the assets of the corporation, but were taxable if the surplus was accumulated from earnings or profits of the corporation prior to the incidence of the tax. This decision was reversed by the Supreme Court (247 U. S. 330), but only on the ground that the corporation which paid the dividend and the corporation which received it were in substance identical corporations, the stockholder, therefore, not being the ordinary stockholder contemplated in Lynch v. Hornby. See also Hays v. Gauley Mountain Coal Co., 247 U. S. 189; U. S. v. Cleveland etc., Ry. Co., 247 U. S. 195; Doyle v. Mitchell Bros., 247 U. S. 179; Gulf Oil Corporation v Lewellyn, 248 U. S. 71 and T. D. 2740.

53 Letter from Treasury Department dated July 23, 1917; I. T. S. 1918, ¶ 284.

54 Letter from Treasury Department dated October 19, 1915; I. T. S. 1918, ¶ 734. The principle of the decision in the Matter of Osborne, 209 N. Y. 450 was referred to in this letter and held to have no application to the income tax law.

tions is not taxable to the corporation. Upon amalgamation with other funds of the corporation such income loses its identity. When distributed to stockholders as a dividend, the entire amount of the dividend is subject to inclusion in returns of income for the purposes of the income tax.[55]

Distribution from Depletion or Depreciation Reserve. A reserve set up out of gross income by a corporation and maintained for the purpose of making good any loss of capital assets on account of depletion or depreciation is not a part of its surplus out of which ordinary dividends may be paid. A distribution made from such a reserve will be considered a liquidating dividend and will constitute taxable income to a stockholder only to the extent that the amount so received is in excess of the cost or fair market value as of March 1, 1913, of his shares of stock. No distribution, however, will be deemed to have been made from such a reserve except to the extent that the amount paid exceeds the surplus and undivided profits of the corporation. In general, any distribution made by a corporation other than out of earnings or profits accumulated since February 28, 1913, is to be regarded as a return to the stockholder of part of the capital represented in his shares of stock, and upon a subsequent sale of such stock his profit will be the excess of the selling price over the cost of the stock or its fair market value as of March 1, 1913, after applying on such cost or value the amount of any such capital distribution.[56]

Cash Dividends. Where a dividend is paid in cash, or by check, which is the equivalent of cash, the dividend becomes taxable to the recipient in the year in which it is received, not necessarily in the year in which it is declared.[57]

Scrip Dividends. When a dividend is paid in scrip it is held to be equivalent to a payment in cash and an investment of the cash in the scrip. The dividend, therefore,

55 Reg. 33 Rev., Art. 4.

56 Reg. 45, Art. 1548.

57 Letter from Treasury Department, dated February 18, 1915; I. T. S., 1918, ¶ 271. Revenue Act of 1918, § 213 (a).

must be included in the return at the face value of the scrip.[58] If at a later date the face value of the scrip is not realized in cash a loss may be claimed in the year in which the stockholder parts with the scrip.

Dividends Paid in Equivalent of Cash. The Revenue Act of 1918 includes in its definition of the term "dividends" any distribution made by a corporation to its shareholders or members whether in cash or in other property or in stock of the corporation.[59] Although the 1916 Law in its definition of the term "dividends" expressly stated that a dividend should be a payment in cash or in stock of the corporation, that law did not seem to contemplate that no tax should accrue if the payment was made in the equivalent of cash. Dividends declared by a corporation and paid with securities in which the surplus of the corporation had been invested, regardless of the character of such securities, is to be accounted for as a dividend for income tax purposes by the recipients of same to the extent that it represented a distribution of surplus accrued to the corporation since March 1, 1913.[60] In a case[61] arising under the 1913 Law a distribution in stock of another corporation was held not to be a stock dividend and was held to be taxable even though it partially represented surplus acquired prior to March 1, 1913. In cases where a dividend is paid in securities, the value of which has depreciated, the value of the securities at the time of their receipt by the stockholders has been held by the Treasury Department to measure the money value of the dividend,[62] but the price paid by the corporation for the securities is in fact the amount of surplus distributed, and should the

58 Letter from Treasury Department dated January 19, 1915; I. T. S. 1918, ¶ 260. Scrip dividends were held taxable under the Act of June 30, 1864, Bailey v. Railroad Company, 106 U. S. 109.

59 Revenue Act of 1918, § 201 (a).

60 Reg. 33 Rev., Art 4.

61 Peabody v. Eisner, 247 U. S. 347.

62 Letter from Treasury Department dated November 12, 1918, I. T. S., 1918, ¶ 3696.

securities have increased in value between the time they were acquired and the time they are distributed by the corporation, the ruling of the Department may be different.

DIVIDENDS PAID IN LIBERTY BONDS. The fact that dividends are paid in Liberty Bonds does not make that income exempt from tax. The tax is upon the income itself as an entirety and not upon the specific articles into which this income is finally transmuted. When Liberty Bonds are used as a medium of payment, whether in discharge of a private debt or a corporate dividend, profit or gain to the recipient is nevertheless subject to income tax.[63] The stockholder should make return of the dividend paid in Liberty Bonds on the basis of the cash value of the Liberty Bonds at the time of their receipt by him.[64]

TAXES PAID FOR SHAREHOLDERS TO BE CONSIDERED AS DIVIDENDS. Where a corporation, such as a bank, pays taxes assessed upon the respective interests of its shareholders, under laws which require the corporation to pay such taxes on behalf of its shareholders, the pro rata amount so paid on his shares should be reported by the stockholder as a dividend. The same amount may also be deducted as a tax of the stockholder paid for him by the corporation as his agent. The net result of reporting such amount as a dividend, and claiming the same amount as a deduction, is that the amount of tax is offset against the stockholder's income from other sources in assessing the normal tax.[65]

63 Letter from Treasury Department dated June 30, 1917, I. T. S., 1918, ¶ 285; Letter from Treasury Department dated June 22, 1917, I. T. S., 1918, ¶ 309. The second of these letters is based upon an opinion on the subject obtained from the Attorney General by the Treasury Department. The question was raised by reason of the language of the Act authorizing the first issue of Liberty Bonds (Act of April 24, 1917, Public No. 3.) which exempted the principal and income from taxation.

64 Letter from Treasury Department, dated, November 12, 1918, I. T. S. 1918, ¶ 3696.

65 For a further discussion of this subject, see Chapter 29 on Deduction of Taxes.

Stock Dividends. The Revenue Act of 1918, expressly provides that stock dividends shall be taxable. It defines a stock dividend as a distribution made by a corporation, other than a personal-service corporation, to its shareholders or members, in stock of the corporation out of its earnings or profits accumulated since February 28, 1913, or in the case of a personal-service corporation any such distribution out of earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.[66] It also provides that a dividend paid in stock of the corporation shall be considered income to the amount of the earnings or profits distributed.[67] A stock dividend is at most only taxable where a cash dividend would be taxable. Any distribution made in the form of a stock dividend, which would not be taxable if made in the form of a cash dividend, is not made taxable by reason of the distribution being made in stock. It should be noted in connection with this discussion of the taxability of stock dividends that a stock dividend is a distribution by a corporation to its stockholders of capital stock of the distributing corporation. A distribution of capital stock other than that of the distributing corporation is not a stock dividend, but a dividend in property, or specie and is governed by the same rule applicable to the distribution of a like value in money.[68] As appears in a later paragraph, it has been held by a Federal District Court that the provision of the 1916 Law by which stock dividends were in terms stated to be income, and to be taxable as such to the same extent as are cash dividends, is unconstitutional.[69] The Treasury Department, however, will assess the tax on stock dividends until the point has been settled by the United States Supreme Court.

[66] Revenue Act of 1918, § 201 (a).

[67] Revenue Act of 1918, § 201 (c).

[68] Peabody v. Eisner, 247 U. S. 347. See T. D. 2740; Mimeograph Letter to collectors, No. 1795; I. T. S. 1918, ¶ 3107.

[69] Macomber v. Eisner, (U. S. Dist. Ct., So. Dist. of N. Y.). See I. T. S. 1918, ¶ 3718.

RULE UNDER 1916 LAW. The 1916 Law expressly provided that stock dividends should be taxable. It defined a stock dividend as a distribution by a corporation out of its earnings or profits accrued since March 1, 1913, and payable to its shareholders in stock of the corporation. It was provided that such stock dividends should be considered income to the amount of the earnings or profits so distributed.[70] Notwithstanding the broad language in the opinion quoted at length in the following paragraph, the Treasury Department declared that since only the language of the 1913 Law and not the language of the 1916 Law was before the Court in that case, it did not necessarily follow that stock dividends were not taxable under the provisions of the 1916 Law and the 1917 Law, and that it would continue to be governed by the express provision in the 1916 Law taxing stock dividends, and would assess the tax on such dividends unless and until the Supreme Court held otherwise.[71] This also expresses the position of the Treasury Department under the present law.

RULE UNDER 1913 LAW. The 1913 Law was silent as to stock dividends, and it was at first held by the Treasury Department that such dividends were not subject to tax, on the theory that the additional shares of stock issued to the stockholder represented no more than the same interest in the identical property represented by his stock before the dividend. The Treasury Department subsequently changed its attitude and held stock dividends to be the equivalent of cash and to constitute taxable income under the same conditions as cash dividends.[72] As to the 1913 Law, this

70 Revenue Act of 1916, § 31, added by Revenue Act of 1917. The 1916 Law prior to the amendment contained substantially the same definition of stock dividends.

71 Letter to Collectors dated January 10, 1918; I. T. S. 1918, ¶ 2279. In the opinion of the Treasury Department the Court did not decide that such dividends cannot be income within the meaning of the Sixteenth Amendment, but expressly recognized that the word "income" may have a different meaning in the Statute from the meaning in the Constitution.

72 T. D. 2274, dated December 22, 1915.

ruling of the Treasury Department has been reversed by decision of the United States Supreme Court in a case holding that stock dividends were not taxable. In that case[73] the Court said in part: "Notwithstanding the thoughtful discussion that the case received below we can not doubt that the dividend was capital as well for the purpose of the Income Tax Law as for the distribution between tenant for life and remainderman. What was said by this Court upon the latter question is equally true for the former. 'A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interest of the shareholders. Its property is not diminished and their interests are not increased. * * * The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones.' Gibbons v. Mahon, 136 U. S. 549, 559, 560. In short, the corporation is no poorer and the stockholder is no richer than they were before. Logan County v. United States, 169 U. S. 255, 261. If the plaintiff gained any small advantage by the change it certainly was not an advantage of $417,450, the sum upon which he was taxed. It is alleged and admitted that he received no more in the way of dividends and that his old and new certificates together are worth only what the old ones were worth before. If the sum had been carried from surplus to capital account without a corresponding issue of stock certificates, which there was nothing in the nature of things to prevent, we do not suppose that any one would contend that the plaintiff had received an accession to his income. Presumably his certificate would have the same value as before. Again if certificates for $1,000 par were split up in ten certificates, each for $100, we presume that no one would call the new certificates income. What has happened is that the plain-

[73] Towne v. Eisner, 245 U. S. 418.

tiff's old certificates have been split up in effect and have diminished in value to the extent of the value of the new." After this decision was rendered the Treasury Department announced that it would refund all taxes based on income from stock dividends reported by taxpayers under the 1913 Law, that is, for the years 1913, 1914 and 1915. In claiming such refunds the taxpayer was required to show by affidavit: (1) The name of the corporation which declared and paid the stock dividend; (2) The date of declaration of the stock dividend and date of receipt by claimant; (3) In which year's return of annual net income the claimant included the stock dividend; (4) Under what item on the return the value of the stock dividend was included, and what valuation was placed upon the dividend in the return; (5) Whether or not the stock thus received and returned as a dividend had been sold by the claimant, and if so, (a) the date of sale, (b) the amount claimant received therefrom, and (c) what part of the total amount received from the sale was included by the claimant in his return of annual net income for the year in which the sale occurred; and (6) Whether or not the dividend consisted of stock of the corporation distributing the dividend to claimant, or of stock acquired by the distributor in another corporation.[74]

CONSTITUTIONALITY OF TAXING STOCK DIVIDENDS WITHOUT APPORTIONMENT. The Sixteenth Amendment to the Federal Constitution authorized Congress "to lay and collect taxes on incomes from whatever source derived, without apportionment." The whole purpose of this amendment has been held to be to relieve income taxes, when imposed, from the requirement of apportionment; it in no way enlarged the power of Congress to levy income taxes.[75] It has been contended by the Treasury Department that the Supreme Court did not decide that stock dividends cannot be income within the meaning of the above constitutional

[74] Mimeograph Letter to Collectors, No. 1795; I. T. S. 1918, ¶ 3107.
[75] Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

amendment in the Towne case [76] referred to above, wherein it was held that stock dividends were not taxable under the 1913 Law, but expressly recognized that the word income may have different meanings, as used in the Statute and the Constitution.[77] On the other hand, it has been argued that the Supreme Court was not construing the 1913 Law in the Towne case, but was considering the broad question whether or not a stock dividend is fundamentally and essentially income within the meaning of that term as used in the Sixteenth Amendment; in other words, whether or not Congress has power under the Constitution to tax stock dividends without apportionment. In support of this argument it is urged that the Supreme Court was obliged to place its decision in the case of Towne v. Eisner upon constitutional grounds because of the Government's contention that under the sweeping language of the 1913 Law, stock dividends must have been considered taxable if they were income, and that a decision that they were not taxable was equivalent to a decision that they were not income. It is also to be noted in this connection that the dividends involved in the Towne case were from profits earned before January 1, 1913. The Supreme Court by a later decision [78] has removed the possibility that its decision in the Towne case was based upon this ground. The view that the decision denied the constitutional right of Congress to levy an income tax upon stock dividends has been adopted in a recent case in a lower federal court, decided under the 1916 Law, which expressly taxed stock dividends. The court in this case decided that the provision of the 1916 Law by

[76] Towne v. Eisner, 245 U. S. 418.

[77] Letter from Treasury Department to Collectors dated January 10, 1918, I. T. S., 1918, ¶ 2279.

[78] Lynch v. Hornby, 247 U. S. 339. In this case the Court held under the 1913 Law that dividends declared and paid in the ordinary course by a corporation to its stockholders after March 1, 1913, whether from current earnings or a surplus accumulated prior to that date, were taxable as income to the stockholders. See also Peabody v. Eisner, 247 U. S. 347; Gulf Oil Corporation v. Lewellyn, 248 U. S. 71; Southern Pacific Co. v. Lowe, 247 U. S. 330.

which stock dividends are in terms stated to be income, and to be taxable as such to the same extent as are cash dividends, was unconstitutional because to impose an income tax upon stock dividends is to tax capital or principal, contrary to the requirement that direct taxes be laid by apportionment among the several states according to population.[79] Taxpayers against whom a tax is assessed under the 1916 Law and the Revenue Act of 1918 on stock dividends should exercise care in paying the tax under protest and duress in order to protect their rights to recovery.[80] Where stock dividends are reported in the return of income, care should be taken that they are segregated from cash dividends and that it be clearly shown either on the return or on a rider attached to the return that the dividend was paid in stock and that the amount is reported not as an admission of liability for tax thereon, but out of courtesy to the Commissioner and in order to avoid the imposition of penalties for an alleged false or fraudulent return.

MONEY VALUE OF STOCK DIVIDENDS. The Revenue Act of 1918 provides[81] that dividends paid in stock of the corporation shall be considered income "to the amount of the earnings or profits distributed." The 1916 Law as amended by the 1917 Law, contained a substantially similar provision.[82] Prior to this amendment, the 1916 Law provided that a stock dividend should be taxable "to the amount of its cash value." Both phrases were construed to have the same meaning. Under the law and the regulations stock

79 Macomber v. Eisner, (U. S. Dist. Ct., So. Dist. of N. Y.) decided January 23, 1919, I. T. S. 1918, ¶ 3718. Judge Mayer overruled the demurrer of the Government to the complaint in this case upon the authority of Towne v. Eisner, 245 U. S. 418, and Peabody v. Eisner, 247 U. S. 347. It is understood that the Government will immediately appeal from this decision to the United States Supreme Court.

80 See Chapter 35 on Assessment and Payment of the Tax for the rules respecting payment under protest and duress.

81 Revenue Act of 1918, § 201 (c).

82 Revenue Act of 1916, § 31, as amended by the Revenue Act of 1917.

dividends received in 1916 and subsequent years are held to be income to the stockholder as though cash equivalent to the par value of the stock had been received as a dividend instead of the stock, unless the par value does not represent the amount of surplus transferred to capital account as a result of the dividend. In the case of shares without par value the value of the stock for the purpose of taxation would be the amount of surplus transferred by the corporation to capital as a result of the dividend. Thus if a corporation declared a dividend of $100,000 from its surplus to be paid in one thousand shares of stock of the corporation the Treasury Department holds that each share received by the stockholders represented the equivalent of $100 of cash. It is immaterial that the market price of the stock so received is greater or less than the amount of surplus represented by the distribution.

Income Derived on Sale of Stock Received as Dividend. The question of taxability of stock dividends refers only to its taxability at the time it is received as a dividend. Under the 1913 Law, for example, a taxpayer may unquestionably have received a stock dividend without being subject to any tax at the time of its receipt. If subsequently he sells that stock there seems to be no question but what the amount he receives may represent a profit or loss under the provisions of the law relating to the sale of property. The rules for determining the profit or loss is affected by several considerations. On this subject the Treasury Department has ruled as follows:

1. In the case of stock (a) received as a dividend in 1913, 1914 or 1915 out of surplus, however created, or (b) received as a dividend in 1916 or subsequent years out of surplus other than earnings or profits accrued since March 1, 1913, the cost[83] of each share of new stock is the quotient of the cost of the old stock divided by the number of old and new shares added together.

[83] The word "cost" is used to indicate the cost if the stock was purchased on or after March 1, 1913, or the value on that date if purchased prior thereto.

2. In the case of the stock in respect of which any stock dividend was paid as described under 1, the cost of each share of old stock is similarly the quotient of the cost of the old stock divided by the number of old and new shares.

3. In the case of stock received as a dividend in 1916 or subsequent years out of surplus earnings or profits accrued since March 1, 1913, the cost of each share is the valuation at which it was returnable as income, as shown by the transfer of surplus to capital account on the books of the corporation, usually its par value.

4. In the case of the stock in respect of which any stock dividend was paid as described under 3, the cost of each share is its original cost, regardless of any stock dividend.[84]

Stock Dividends Resulting from Revaluation of Assets. If a corporation has earnings or surplus accumulated since February 28, 1913, any distribution will be deemed to be from such earnings until they have been distributed.[85] If a corporation has no earnings or surplus accumulated after February 28, 1913, it may issue a stock dividend to distribute surplus created from the revaluation of capital assets or to represent value placed upon trademarks, good will, etc., and such dividends are not income to the shareholder. When stock received in payment of such a dividend, or stock in respect of which any such dividend was paid, is sold, the cost of each share of stock, whether old or new, for the purpose of ascertaining the gain or loss resulting from its sale, is the quotient of the cost of the old stock, if acquired on or after March 1, 1913, or its fair market price or value as of that date if acquired prior thereto, divided by the number of old and new shares added together. The profit so ascertained from the sale of such stock is income subject to both normal and surtax in the year in which the sale is made.[86]

84 T. D. 2734; Reg. 33 Rev., Art. 4, as amended by T. D. 2734. See also letter from Treasury Department dated October 30, 1916, I. T. S., 1918, ¶ 256. Letter from Treasury Department dated March 24. 1916 I. T. S., 1918, ¶ 257.

85 Letter from Treasury Department dated May 14, 1918; I. T. S. 1918, ¶ 3376.

86 T. D. 2734.

CHAPTER 24

INCOME FROM ROYALTIES

Under the 1916 Law and prior laws the Treasury Department expressly required that royalties from mines, oil wells, patents, franchises, or other legalized privileges be separately reported by the individual, but not by corporations. No particular rules have been issued with respect to royalties and with respect to income from royalties, except to hold that royalties received by a corporation in accordance with a contract by which it has assigned the patent rights to manufacture machines, etc., are income and should be so accounted for,[1] and that royalties paid to a proprietor by those who are allowed to develop or use property or operate under some right belonging to such proprietor are also to be accounted for as income.[2] In the case of mines operated by a lessee on a royalty basis, the amount of royalty received by the lessor is income.[3]

Royalties from Mines. It has been contended that royalties received under mining leases and oil leases are in fact not income but payments of installments on the purchase price of the natural deposit. The nature of such leases has been the subject of some difference of opinion in the courts. It has been held that the leases are such in name only, and are in fact conveyances of the ore body in place as a part of the realty, and that the so-called royalties merely represent payments for so much land and are in

[1] Reg. 33 Rev., Art. 113. Letter from Treasury Department dated January 24, 1916; I. T. S. 1918, ¶ 1262.

[2] Reg. 33 Rev., Art. 4.

[3] T. D. 2152.

no just sense income, but mere conversions of the capital. On the other hand, it has been held that such leases do not constitute a sale of any part of the land and further, that ores or other materials derived from the usual operation of open mines or quarries, constitute the rents and profits of the land. The United States Supreme Court in a case [4] arising under the 1909 Law reviewed the conflicting authorities, and held that under the language of that law royalties received under mining leases were income. In another case [5] the lessee had the right or privilege of removing the ore so long as he saw fit to hold the same without exercising the privilege of cancellation, but nevertheless he was held to be in no legal sense a purchaser of ore in place. Such royalties are treated as income, against which the owner of the property may claim an allowance for depletion of the natural resource.

Royalties from Patents and Copyrights. Taxpayers receiving royalties from patents, copyrights, or other similar forms of property, may deduct from each payment a proportionate part of the cost thereof as representing a return of capital. This is more fully discussed in a subsequent chapter.[6]

Royalties Received by Non-Resident Aliens. Royalties paid to non-resident aliens under an agreement of purchase of certain patent rights, the payment being based upon the quantity of goods produced by the use of such patents, are held to be income accruing to non-resident aliens by reason of property owned or business carried on within the United States.[7]

[4] Von Baumbach v. Sargent Land Co., 242 U. S. 503.
[5] U. S. v. Biwabik Mining Co., 247 U. S. 116, reversing 242 Fed. 9.
[6] Reg. 45, Arts. 45, 163; see chapter 31.
[7] T. D. 2137.

CHAPTER 25

INCOME FROM MISCELLANEOUS SOURCES

After specifying a number of sources of income, the act provides that the net income of the taxpayer shall include gains or profits and income derived from any source whatever.[1] In this chapter are set forth the rulings on income from sources not covered by the preceding chapters and on receipts which are not income.

Alimony. Alimony is not income, as it does not arise from any business transaction, and is not founded on any contract, but on the natural and legal duty of the husband to support the wife.[2] It follows that the husband cannot deduct the amount he pays as alimony from his income for the purpose of the tax.

Accident, Health or Workmen's Compensation Insurance. Amounts received through accident or health insurance or under workmen's compensation acts as compensation for personal injuries or sickness are exempt from income tax and the amount of any damages received, whether by suit or agreement on account of such injuries or sickness is also exempt.[3]

1 Revenue Act of 1918, § 213 (a).

2 Gould v. Gould, 245 U. S. 151. This decision reversed the ruling of the Treasury Department on the point.

3 Revenue Act of 1918, § 213 (b) 6. Money paid to a person insured by an accident insurance policy on account of accident was first considered income (to the extent that the amount exceeded the aggregate premiums paid) but amounts received from a railroad company, by way of reimbursement for expenses incident to an accident were not income. But these rulings were revoked and it was held in pursuance of an opinion of the Attorney General based upon Doyle v. Mitchell Brothers, 247 U. S. 179, affirming

Assessments on Stock. Assessments paid by stockholders on stock are not income of the corporation, nor is a voluntary contribution on the part of the stockholders, to make good a deficit of the corporation. Such payments are simply an addition to the capital stock of the company.[4]

Cancelled Debts. Cancellations of debts do not ordinarily create income to the debtor.[5] The rule might be otherwise, however, in case the cancellation was in consideration of services rendered, since the law provides that compensation for personal services, in whatever form paid, is income.

Allocation of Income from Judgments. Lands which are received as compensation for services in one year, the title to which is disputed and in a later year adjudged to be valid, constitute income to the grantee in the former year. On the other hand, a person may sue in one year on a pecuniary claim or for property, but money or property recovered on a judgment therefor rendered in a later year would be income in that year, assuming that it would have been income in the earlier year if then received. In general, a judgment for the plaintiff may produce income; a judgment for the defendant usually does not. However, money paid by a debtor to a receiver, pending determination as to which of two or more claimants other than the debtor is entitled to it, is to be treated as income of the successful claimant in the year when paid to the receiver. Bad debts or accounts charged off because of the fact that they were determined to be worthless and subsequently recovered, whether or not by suit, constitute income for the

235 Fed. 686, Lynch v. Turrish, 247 U. S. 221, and Southern Pac. Co. v. Lowe, 247 U. S. 330, that the proceeds of accident insurance policies received by an individual on account of injuries sustained by him through accident were not income under the 1916 Law as amended (T. D. 2747).

4 Letter from Treasury Department dated February 21, 1916; I. T. S. 1918, ¶ 1291.

5 U. S. v. Oregon-Washington etc. Co., 251 Fed. 211.

year in which recovered, regardless of the date when the amounts were charged off.[6]

Damages. The amount of any damages received, whether by suit or agreement, on account of personal injuries or sickness, is exempt from income tax.[7]

DAMAGES FOR PROPERTY LOST OR DESTROYED. It was held generally under the 1916 Law that when an individual, partnership or corporation as a result of suit or otherwise secured payment for damages which it might have sustained, and the amount of such payment exceeded an amount necessary to make good the damage or damaged property, the amount of such excess was considered income for the year in which received. If the entire or an estimated amount of the damage had been previously charged off and deducted from gross income, then the amount recovered was to be returned as income. If the amount recovered was less than the damage sustained or less than an amount necessary to make good the damage, the difference between the actual amount of damage sustained and the amount recovered was deductible as a loss.[8]

Compensation for Property Requisitioned or Lost or Destroyed Through War Hazards. The ruling mentioned in the previous paragraph was later modified as follows: In the case of property, title to which has been requisitioned for war uses, or property which has been lost or destroyed in whole or in part through war hazards, the amount received by the owner as compensation for the property may show an excess over the value of the property on March 1, 1913, or over its cost if it was acquired after that date. This excess of the amount received over the value or cost of the property, except so far as actually used for the replacement of the property in kind, is sub-

6 Reg. 45, Art. 46.

7 Revenue Act of 1918, § 213 (b) 6. Under the 1916 Law amounts received as the result of a suit or compromise for "pain and suffering" were at first held to be income. (T. D. 2135). This rule was subsequently revoked. (T. D. 2747).

8 Reg. 33 Rev., Art. 94, as modified by T. D. 2706.

ject to the income, war income and excess-profits taxes. Although the intention or obligation of the taxpayer in such case may be to use the entire sum received as compensation for the replacement in kind of the lost or damaged property, it is recognized that it may not be practicable, owing to war conditions, to make such replacement for a considerable time. In such case, the taxpayer may establish a "replacement fund" in which the entire amount of the compensation so received shall be held, and pending the disposition thereof, the accounting for gain or loss thereupon may be deferred for a reasonable period of time to be determined by the Commissioner. Where the property requisitioned, lost or damaged constituted all or part of the security under a mortgage or trust indenture, the amount carried to the replacement fund may, subject to the approval of the Commissioner, be the amount of compensation received less the amount, if any, which becomes payable out of such compensation under the terms of such instrument or the obligation thereby secured.[9] This ruling was later extended to embrace other losses, as follows:

Loss or Damage Recovered. In the case of property which has been lost or destroyed in whole or in part through fire, storm, shipwreck, or other casualty, or where the owner of property has lost or transferred title by reason of the exercise of the power of requisition or eminent domain, including cases where a voluntary transfer or conveyance is induced by reason of the fact that a technical requisition or condemnation proceeding is imminent, the amount received by the owner as compensation for the property may show an excess over the value of the property on March 1, 1913, or over its cost, if it was acquired after that date (after making proper provision in either case for depreciation to the date of the loss, damage, or transfer). The transaction is not regarded as completed at this stage, however, if the taxpayer proceeds immediately in good faith to replace the property, or if he makes application to estab-

9 T. D. 2706, modifying Reg. 33 Rev., Art. 94; and T. D. 2733.

lish a replacement fund as provided in the following article. In such a case the gain, if any, is measured by the excess of the amount received over the amount actually and reasonably expended to replace or restore the property substantially in kind, exclusive of any expenditures for additions or betterments. The new or restored property effects a replacement in kind only to the extent that it serves the same purpose as the property which it replaces without added capacity or other element of additional value. Such new or restored property shall not be valued in the accounts of the taxpayer at an amount in excess of the cost or value at March 1, 1913, if acquired before that date (after making proper provision in either case for depreciation to the date of the loss, damage, or transfer) of the original property, plus the cost of any actual additions and betterments. If the taxpayer does not elect to replace or restore the property, the transaction will then be deemed to be completed and the income shall be measured by the excess of the amount of the compensation received over the cost of the property or its actual value at March 1, 1913, if acquired before that date (after making proper provision in either case for depreciation to the date of the loss, damage, or transfer). This ruling, however, has no application to property which is voluntarily sold or disposed of.[10]

Replacement Fund for Losses. In any case in which the taxpayer elects to replace or restore the lost, damaged, or transferred property, but where it is not practicable to do so immediately, he may obtain permission to establish a replacement fund in his accounts in which the entire amount of the compensation so received shall be held, without deduction for the payment of any mortgage, and pending the disposition thereof the accounting for gain or loss thereupon may be deferred for a reasonable period of time, to be determined by the Commissioner.[11]

Application for Replacement Fund. In a case speci-

10 Reg. 45, Art. 47.
11 Reg. 45, Art. 48.

fied in the preceding article the taxpayer should make application to the Commissioner on form 1114 for permission to establish such a replacement fund and in his application should recite all the facts relating to the transaction and undertake that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such security or surety as the Commissioner may require for an amount not less than the estimated additional excess profits and income taxes assessable by the United States upon the income so carried to the replacement fund; or at the option of the taxpayer and in lieu of such bond the taxpayer may deposit, as security for such estimated additional amount of tax, obligations of the United States issued after September 1, 1917, such obligations to be held in trust as such security under such agreement as may be prescribed by the Commissioner in a bank or trust company approved by him. The estimated additional income and excess profits taxes, for the amount of which the claimant is required to furnish security, should be computed at the rates at which the claimant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary as acceptable sureties on federal bonds will be approved as sureties under schedule B of form 1114, and only active depositaries of public moneys will be approved as depositaries under schedule C. The application should be executed in triplicate, so that the Commissioner, the applicant, and the surety or depositary may each have a copy.[12]

Increment to Sinking Funds. Where a sinking fund is set aside for the purpose of meeting obligations at a future date, all increment to that fund as a result of investments is income to the creator of the fund. Where a sinking fund, controlled by trustees, has been invested in the

12 Reg. 45, Art. 49.

bonds of the corporation which created the fund, and the corporation pays the trustees interest on such bonds, the amount of interest may be deducted, the same as payment to any other bondholders, and within the limitation fixed by law, but the same amount must be included as income to the corporation from the sinking fund.[13]

Legacies. A legacy is a gift and the value thereof is not considered income to the recipient, but all income created by the legacy is taxable. Unless clearly inconsistent with the intention of the testator, a legacy is held to be vested rather than contingent, and where there is a vested interest the income therefrom, whether distributed or not by the executor or administrator, is subject to the tax from the time of death of the testator, as income of the legatee.[14]

Pensions. Pensions paid by the United States Government are subject to the income tax,[15] as also are pensions paid by any other government, or by any private interest, under any contract express or implied. If, however, a so-called "pension" is a mere gratuity or gift it is not taxable as income to the recipient.

Proceeds of Life Insurance. The proceeds of life insurance policies paid upon the death of the insured are exempt from tax under the Revenue Act of 1918 if paid to individual beneficiaries or to the estate of the insured, but not if paid to a corporation beneficiary.[16] The Treasury Department has ruled that if the insurance proceeds are paid to a partnership they are not exempt income, but this is doubtful since a partnership is merely two or more in-

13 T. D. 2161.
14 T. D. 2090.
15 T. D. 2090.
16 Revenue Act of 1918, §§ 213 (b) and 233 (a). The 1916 Law provided that the proceeds of life insurance policies were exempt only when paid to an individual beneficiary upon the death of the insured, and not when paid to the estate of the insured. The Senate introduced a provision in the 1918 Revenue Bill to exempt the proceeds of life insurance policies regardless of to whom they were paid but the Conference Committee limited the exemption to proceeds paid only to individual beneficiaries or to the estate of the insured.

dividuals.[16a] If the proceeds are paid in installments under the terms of the policy none of the installments are subject to tax, but, it appears, if the proceeds are paid in installments by agreement between the beneficiary and the insurance company the installments are free from tax until they aggregate the amount of insurance payable on the death of the insured, and any amount in excess of that sum, due to deferring the payments, is income. Where an individual is the beneficiary it seems to be immaterial whether or not the premiums were paid by the insured or by the beneficiary, since the law grants an absolute exemption with respect to the proceeds of the policy. In the case of a corporation being the beneficiary of insurance taken out on the lives of officers or of employees the proceeds less the total of any premiums paid thereon (and not deducted from net income in the year in which paid, as was permitted prior to the year 1917) is held to be income.[17] There may be a question of arbitrary discrimination in this respect between individual and corporation beneficiaries, which will no doubt give rise to litigation. Further, it seems that the insurance proceeds received by an employer are intended to compensate him for the loss of services of the insured and it may be argued that the loss, in part at least, offsets the income from the insurance policy.

Property Acquired by Gift. The value of property acquired by gift, bequest, devise or descent (but not the income from such property) is exempt.[18] Such property need not be reported as income by the recipient.[19] It was held under the 1913 Law that gifts to corporations were not exempt, but this ruling did not apply under the 1916 Law, since the provision of the 1913 Law exempting income of this character was contained in the subdivision applying particularly to individuals, while in the 1916

16a Reg. 45, Art. 72.

17 Letter from Treasury Department dated March 15, 1918, I. T. S. 1918, ¶ 3290.

18 Revenue Act of 1918, §§ 213 (b) and 233.

19 Revenue Act of 1918, §§ 213 (b) 3, 233 and 239.

Law it was placed in a section having general reference to all taxpayers. Under the 1916 Law income of this character was exempt from the tax regardless of the status of the recipient.[20] This is clearly the rule under the Revenue Act of 1918.[21]

DEFINITION. Christmas presents, gratuities, voluntary contributions and donations are considered as gifts and should not be reported as income by the recipient. An exception, however, is made in the case of clergymen; Easter offerings, and fees received by them for funerals, masses, marriages, baptisms, etc., while in the form of gifts, are in fact payment for services and should be reported as income.[22] Special payments made by an employer as extra compensation to employees are sometimes called bonuses or gifts, but if clearly made as compensation for services rendered, and paid in pursuance of a contract, express or implied, or if combined with the regular salary of the employee they do not exceed a reasonable compensation, they are in fact not gifts but income from services, and taxable to the recipient.[23] Where the salary of an employee is paid for a limited period after his death to a relative or dependent, in recognition of the services rendered by the employee, no services being rendered by the recipient, the payments are gifts and exempt from taxation.[24] Of course, any amount paid by one person out of his income to another, as a gift, is not deductible from the net income of the giver.[25]

SALE OF PROPERTY ACQUIRED BY GIFT. When property acquired by gift is thereafter sold, the value of the property at the time the gift was made is deducted from the amount received on the sale thereof and the remainder

20 Compare Revenue Act of 1916, § 4 with Act of October 3, 1913, ¶ B.

21 Revenue Act of 1918, §§ 213 and 233.

22 Reg. 45, Art. 107, T. D. 2090.

23 Reg. 45, Art. 107, T. D. 2606.

24 T. D. 2090, Reg. 33, Art. 6.

25 See Chapter 26 on Deductions.

is taxable as income of the seller. If the property was received as a gift prior to March 1, 1913, its value on that date would be so deducted.

Recoveries on Bad Debts. Where a bad account has been charged off to profit and loss and subsequently the money is recovered, the sum so recovered must be treated as income whether or not the bad debt was charged off prior to the incidence of the tax or subsequent thereto. The fact that a bad debt has been charged off prior to the incidence of the tax does not make it any the less income for the year in which it is recovered.[26]

Rights to Subscribe to Stock. Where a stockholder acquires the right to subscribe to new stock of the corporation and sells that right, the amount received is considered as income.[27] If he exercises the right, no income accrues until the stock subscribed for is sold.

Stock Received as Bonus. Where common stock is received as a bonus in consideration of the purchase of preferred stock, the common stock has no taxable status. The entire proceeds derived from the sale or transfer of such stock is income subject to the normal and surtax.[28]

Sale of Bonds at Premium. If bonds are sold at a premium, the premium must be reported as income.[29]

Dividends on Life Insurance Policies. Dividends paid on life insurance policies that have not matured, whether or not such dividends are drawn in cash by the insured or applied to the reduction of the annual premium due, are not considered items of taxable income. Dividends from paid-up policies, however, are considered income. The former represent merely a return of a part of the premium theretofore paid by the insured, while the latter represent a distribution of income earned by the insurance com-

[26] Letter from Treasury Department dated February 11, 1916; I. T. S. 1918, ¶ 1211; Reg. 45, Art. 46.

[27] Letter from Treasury Department dated February 27, 1915; I. T. S. 1918, ¶ 420; Reg. 45, Art. 36.

[28] Reg. 33 Rev., Art. 4.

[29] Reg. 33 Rev., Art. 150.

panies on the premiums paid by the insured, and, when paid to the insured, should be treated the same as dividends from corporations.[30]

Surrender Value of Insurance Policies. When an insured person discontinues insurance prior to the maturity of his policy, he is entitled to a certain surrender value which is paid to him by the insurance company. The amount so received represents the return to the insured of a part of the premiums he has paid in the past, and is therefore not income. If the amount should exceed the aggregate of premiums paid, the excess would be taxable income.[31]

Endowment Policies. Where an endowment policy is paid to the insured, it is exempt from tax to the extent that the payment represents a return to the insured of amounts paid by him from time to time as premiums, but is taxable on the excess.[32] Thus, if over a period of years the insured has paid $700 in premiums, and, at the expiration of the term receives $1,000 from the insurance company, $300 of that sum is taxable income, but the $700, representing return of premiums, is not income.

Annuities. The Revenue Act of 1918 provides that the amount received by the insured as a return of premiums paid by him under life insurance, endowment or annuity contracts either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract is exempt from taxation.[33] Under the 1913 Law it was held that the amount by which the sum received exceeded the sum paid and coming into the hands of the person making the contract and payment was income. It was also first held that "when the settlement under such contract and payment is made in more than one payment each payment will be considered as being composed of interest

30 T. D. 2137.

31 Reg. 45, Art. 44, T. D. 2090; T. D. 2152; Letter from Treasury Department dated February 8, 1917, I. T. S. 1918, ¶ 424.

32 Reg. 45, Art. 44, T. D. 2090; T. D. 2152.

33 Revenue Act of 1918, § 213 (b) 2.

and a proportionate part of the principal,'' and ''where the entire annuity is composed of an interest return upon the principal sum paid therefor, the entire annuity is income.''[34] The matter quoted, however, was afterward stricken out of the ruling.[35] The present ruling is as follows: Annuities paid by religious, charitable and educational corporations under an annuity contract are subject to tax to the extent that the aggregate amount of the payments to the annuitant exceeds any amounts paid by him as consideration for the contract. An annuity charged upon devised land is income taxable to the annuitant, whether paid by the devisee out of the rents of the land or from other sources. The devisee is not required to return as taxable income the amount of rent paid to the annuitant, and he is not entitled to deduct from his taxable income any sums paid to the annuitant. Where an insured receives under life insurance, endowment or annuity contracts, sums in excess of the premiums paid therefor, such excess is income for the year of its receipt.[36]

Matured Shares in Building and Loan Association. Where the amount paid back to a depositor by a building or loan association, at the maturity of the series, exceeds the aggregate deposits made to that series, only the difference between the total amount received for the surrender of the matured certificate and the aggregate of the deposits made by the certificate holder, is to be returned as income.[37]

Compensation by Insurance. Insurance money is clearly a substitute for the assets lost or destroyed. If the insurance money is in excess of the cost of the property it may be used to restore the property or be placed in a fund for that purpose for a reasonable time until restoration can be made, final accounting for tax on the excess over the

[34] T. D. 2090.
[35] T. D. 2152.
[36] Reg. 45, Art. 44.
[37] Letter from Treasury Department dated February 8, 1917; I. T. S. 1918, ¶ 310.

amount expended to replace or restore the property substantially in kind, being deferred until the restoration or replacement has taken place. The rulings on this point are stated above.

CHAPTER 26

DEDUCTIONS—IN GENERAL

In computing the net income of an individual or a corporation certain deductions are specified in the law.[1] While the deductions allowed both corporations and individuals are based upon the same principles, they vary in some particulars, due to differences in the status of the two classes of taxpayers. Thus, an individual may deduct charitable contributions or gifts made within the taxable year, while no corresponding deduction is allowed to corporations. The separate provisions made in the case of individuals for the deduction of losses sustained in any transaction entered into for profit though not connected with trade or business, and losses of property not connected with trade or business, if arising from fires, storms, etc., have no counterparts in regard to corporations, since all losses of a corporation may be deducted. Certain special deductions are allowed in the case of insurance companies which are not necessary in the case of individuals and other kinds of corporations.[2] Dividends from a corporation which is taxable upon its net income, and from a personal service corporation out of earnings or profits upon which income tax has been imposed are allowed as a deduction to corporations and to individuals only as a credit for the purpose of the normal tax. The general effect of the Revenue Act of 1918, as compared with the 1916 Law is to place individuals and corporations more nearly upon

1 Revenue Act of 1918, §§ 214 and 234.

2 These deductions are specially treated in Chapter 13 on Insurance Companies.

the same footing in regard to deductions. The Revenue Act of 1918 also expressly provides that certain items shall not be deductible in the case of both individuals and corporations.[3] In the case of non-resident aliens and foreign corporations the deductions are intended to be limited to such expenses, losses, etc., as are incurred in the creation of the income which is taxed by this Government.[4] The special provisions applicable to individuals, corporations, non-resident aliens and foreign corporations are set forth in the chapters dealing respectively with those subjects. The general provisions applicable to all taxpayers are discussed in this and the following chapters.

Time for Deduction of Charges. Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. A person making returns on an accrued basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes, or other charges, and makes no deduction therefor, he can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities. A loss from theft or embezzlement occurring in one year and discovered in another is deductible only for the year of its occurrence. Any amount paid pursuant to a judgment or otherwise on account of damages for personal injuries, patent infringement, or otherwise, is deductible from gross income when the claim is liquidated or put in judgment or actually paid, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequently thereto, however, a

[3] Revenue Act of 1918, §§ 215 and 235.
[4] Revenue Act of 1918, §§ 216 and 236.

taxpayer has for the first time ascertained the amount of a loss sustained during a prior taxable year and not deducted from the gross income therefor, he may render an amended return for such preceding taxable year, including such amount of loss in the deductions from gross income, and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return.[5]

Only the Deductions Specified in the Statute Are Allowed. It must be borne in mind that although the tax is imposed on the net income of a taxpayer, yet the net income so taxed is that which is defined in the statute,[6] and not that which may be generally termed net income in accounting practice or recognized as such by custom. There may be, for instance, many deductions dictated by prudence and good business management which are not recognized or countenanced by the law. Only those deductions which are expressly specified in the statute may be taken for income tax purposes. But the present law, to a greater degree than any preceding law, follows the lines of commercial usage in defining net income.

Deductions Must Be Actual. The deductions specified in the statute can be deducted by the taxpayer only in case they represent actual payments or actual liabilities. It is not permissible, for instance, for a taxpayer owning the property used and occupied for his or its own business purposes to include as a deduction the rental value of the property so owned. Neither is it permissible to deduct an amount representing the interest which might be earned on the capital employed in the business, if such capital were invested or employed otherwise, or so placed as to earn a given rate of interest.[7] The deductions claimed in any year must ordinarily be those represented by actual cash disbursements unless the taxpayer keeps his books on

[5] Reg. 45, Art. 111.
[6] Revenue Act of 1918, § 212.
[7] T. D. 2137.

some other basis than that of actual receipts and disbursements.

Reporting Deductions According to Book Entries. The present law requires that net income shall be computed in accordance with the method of accounting regularly employed in keeping the books of a taxpayer; but if no such method of accounting has been so employed or if the method employed does not clearly reflect income, the computation is made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect income.[8] Prior to the enactment of this provision reporting income upon any basis other than that of cash receipts and disbursements, was optional with the taxpayer and was in the nature of a special privilege. The Revenue Act of 1918 in consideration of the above provision, uses the words "paid or incurred," or the words "paid or accrued" in connection with many of the deductions specified in the law, and it is also provided that the term "paid" for the purposes of the deductions and credits allowed by the income tax means "paid or accrued" or "paid or incurred" and that the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which net income is computed.[9] No uniform method of accounting is or can be prescribed for all taxpayers. The law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. But the method adopted must be one clearly reflecting his net income. Ordinarily, approved standard methods of accounting will be regarded as clearly reflecting income. All items of gross income and deductions must be treated with reasonable consistency, and the time as of which a deduction is taken must be determined in the light of the fundamental rule that the computation is to be made in such manner as clearly reflects the taxpayer's income.[10]

[8] Revenue Act of 1918, § 212 (b).
[9] Revenue Act of 1918, § 200.
[10] Reg. 45, Art. 22-23. As to 1916 Law, see Reg. 33, Art. 158.

RESERVES TO MEET LIABILITIES. Where pursuant to the consistent practice of accounting of a corporation, or pursuant to the requirements of the Interstate Commerce Commission or of any federal, state or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, the amount of which, and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred, the amount credited to such reserves were permitted to be deducted, under the 1916 Law, provided the amounts deductible on account of the reserves approximated, as nearly as could be determined, the actual amounts which experience had demonstrated would be necessary to discharge the liabilities incurred during the year, for the payment of which additions to the reserves were made. If it was found that the amount credited to any such reserve was in excess of the reasonable or probable needs for which the reserve was created, the excess would be disallowed as a deduction and restored to income for the purpose of the tax.

The Treasury Department has always held, in the case of corporations, that it was immaterial whether deductions, except for taxes and losses, were evidenced by actual disbursements in cash, or evidenced in such other ways as to be properly acknowledged by the corporate officers and so entered on the books of the corporation as to constitute a liability against the assets, except that taxes were deductible only when actually paid, and not merely entered as a charge, and losses when actually sustained in the year charged off. But as to taxes, this rule seems to have been changed in the case of corporations electing under the 1916 Law to report according to their books, by the ruling that corporations which accrued on their books, monthly or at other stated periods, amounts sufficient to meet fixed annual or other charges, might deduct from their gross income the amount so accrued, provided such accruals approximated as nearly as possible the actual liabilities for which the accruals were made, and provided that in cases wherein deductions were made on the accrual basis, income from fixed and determinable sources accruing to the corporation was returned, on the same basis. (T. D. 2433.) Corporations keeping books of account on an accrual basis were permitted to deduct from gross income accrued interest for the year when shown as a charge against accrued income upon the corporate books of account. (T. D. 2625.)

In no event would sinking funds or other reserves set up to meet additions, betterments or other capital obligations be allowed as deductions. Reserves to meet losses contingent upon shrinkage in values, losses from bad debts, losses from capital investments, etc., were not allowed as deductions, since such losses were only deductible when definitely determined as a result of a closed or completed transaction and actually charged off.[11]

Voluntary Destruction of Property. Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements has been held to be deductible from gross income, in a sum representing the difference between the cost of such property demolished or scrapped and an amount measuring a reasonable allowance for the depreciation which the property had undergone prior to its demolition or scrapping; that is to say, the deductible loss is only so much of the original cost, less salvage, as would have remained unextinguished if a reasonable allowance had been charged off for depreciation during each year prior to its destruction. When a taxpayer buys real estate, upon which is located a building which he proceeds to raze, with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building.[12]

Investment of Capital. Investments of capital are not deductible. The following have been held[13] to be investments of capital and not deductible business expenses: (a) Amounts expended for securing copyright and plates

11 T. D. 2433.

12 Reg. 45, Art. 142; Reg. 33 Rev., Arts. 155 and 156. See Reg. 33, Art. 127.

13 Reg. 45, Art. 112; Reg. 33 Rev., Art. 8.

which remain in possession of and as property of the person making the payments. (b) Cost of defending title or perfecting title to property.[14] (c) The amount expended for architect's services.[15] (d) Commissions paid in purchasing and selling securities.[16]

Additional Items Not Deductible. The Revenue Act of 1918 expressly provides that in computing net income no deduction shall in any case be allowed in respect of the items discussed in the following paragraphs.

PERSONAL, LIVING OR FAMILY EXPENSES. The arbitrary credit of $1,000 or $2,000, according to the status of the individual which is permitted for the purpose of the normal tax, is allowed in lieu of personal, living or family expenses and such expenses are expressly stated not to be deductible.[17]

ADDITIONS AND BETTERMENTS. The Revenue Act of 1918 provides expressly in the case of individuals and corporations that no deduction shall be allowed in respect of any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property or estate.[18] Amounts expended for additions and betterments are considered as a capital investment.[19] Thus, expenditures of a railroad for sidings or spur tracks are additions and betterments and therefore not deductible.[20] If expenditures are made for permanent improvements and betterments they are treated as any other investment of capital, that is, if the asset in which the capital is invested is one on which depreciation may be claimed, the amount expended for the permanent addition or betterment is added to the cost of the property

14 Such cost constitutes a part of the cost of the property.

15 Such amounts are a part of the cost of the building.

16 Such commissions are part of the cost or offset against the selling price of the securities.

17 Revenue Act of 1918, § 215 (a).

18 Revenue Act of 1918, §§ 215 (b) and 235.

19 Reg. 33, Art. 118.

20 Grand Rapids & Indiana Ry. Co. v. Doyle, 245 Fed. 792; T. D. 2210.

for the purpose of determining the annual depreciation allowance thereafter. The statute merely intends to prohibit the deduction of the entire amount in the year in which the expenditure is made.

PUBLIC UTILITIES. In a decision under the 1909 Law it was held that the fact that, under the laws of California, a public utilities corporation is not the owner of the property, but merely intrusted with the use thereof, did not entitle it to more favorable treatment than other corporations. Money received from the consumers to pay for service connections to be laid in public streets was held to be income on which the corporation was liable to pay a tax, notwithstanding that all or nearly all of the sums so received may have been expended in betterments and extension of its system. Moneys expended for service connections and pipe extensions are invested in permanent improvements, and do not come within any of the permitted classes of deductions mentioned in the statute.[21] They are not in the nature of improvements made merely to facilitate the transaction of a growing business, the expenses of which have been held deductible.[22]

EXPENSE OF RESTORING PROPERTY. The Revenue Act of 1918 provides expressly in the case of individuals and corporations that no deduction shall be allowed in respect of any amount expended in restoring property or in making good the exhaustion thereof on which an allowance is or has been made.[23] Thus, where an annual allowance has been claimed for depreciation of property subject to wear and tear, the expense of restoring such property may not again be deducted, but must be taken out of the sum so set aside for depreciation.

LIFE INSURANCE PREMIUMS. The Revenue Act of 1918 provides expressly in the case of individuals and corporations that no deduction shall be allowed in respect of pre-

[21] Union Hollywood Water Co. v. Carter, 238 Fed. 329.

[22] See Mutual Benefit Life Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918.

[23] Revenue Act of 1918, §§ 215 (c), 235.

miums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer when the taxpayer is directly or indirectly a beneficiary under such policy.[24]

SPECIAL ASSESSMENTS AGAINST LOCAL BENEFITS. Although assessments against local benefits are frequently referred to as taxes, and are imposed by local governments, they are not deductible as taxes, if "of a kind tending to increase the value of the property assessed."[25] The quoted words were added by the Revenue Act of 1918. Under the 1916 Law, which did not contain this provision, such assessments as, for instance, for paving, curbing, installing sewage and water systems, etc., were held to be expenditures which add to the value of the property and should be capitalized, that is, added to the cost of the property for the purpose of determining the loss or gain in a subsequent sale of such property.[26]

Credits. The net income of the tax payer is ascertained by subtracting the deductions from gross income. The net income so ascertained is subject to surtax if the taxpayer is an individual or to war-profits and excess-profits tax if the taxpayer is a corporation. For the purpose of the normal tax of individuals and the income tax of corporations the net income may be further reduced by the credits specified in the statute. The credits are (a) such items of income as are included in gross income but are not subject to normal tax in the case of individuals or income tax in the case of corporations (i. e. dividends and interest on certain obligations of the United States) (b) the personal exemption in the case of individuals or the amount of the war-profits and excess-profits tax plus $2,000 in the case of corporations.

24 Revenue Act of 1918, §§ 215 (d), 235. See Chapter 27 on Deduction of Business Expenses.

25 Revenue Act of 1918, §§ 214 (a) 3, 234 (a) 3.

26 Letter from Treasury Department dated December 22, 1914; I. T. S. 1918, ¶¶ 521 and 1454.

CHAPTER 27

DEDUCTION OF BUSINESS EXPENSES

The Revenue Act of 1918 permits to corporations the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity.[1] The law permits to individuals the same deduction, except that the property with respect to which rentals, or other payments required to be made, may be deducted, must be used "for purposes of the trade or business" carried on by the individual.[2] The deduction of business expenses is allowed in the case of non-resident aliens and non-resident foreign corporations if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of their deduction with respect to sources of income within and without the United States is determined under the rules and regulations prescribed by the Commissioner with the approval of the Secretary.[3] The special provisions applicable to each of

[1] Revenue Act of 1918, § 234 (a).

[2] Revenue Act of 1918, § 214 (a) 1.

[3] Revenue Act of 1918, §§ 214 (b) and 234 (b). The 1916 Law permitted to individuals the deduction of the "necessary expenses actually paid in carrying on any business or trade," (Revenue Act of 1916, § 5 (a), and in the case of corporations all the ordinary and necessary expenses paid within the year in the maintenance and

these four classes of taxpayers are discussed in the chapters on citizens and residents, non-resident aliens, corporations and foreign corporations, respectively. The discussion in this chapter is limited to the rules applying generally to all taxpayers. As a general rule, the expenses which may be deducted are those necessary for the creation of the income which is taxed. It should be noted, however, that the language of the law contains some express limitations, which are more fully discussed in the following paragraphs.

Deductions Not to Be Duplicated. Where a deduction may, or should be, claimed as one of the items specifically stated in the law, such deduction should not also be included under the head of business expense. Thus, where a deduction is claimed for depreciation, or loss, the same amount should not also be deducted as expense, or if the cost of tools or small articles has been charged to expense, depreciation should not be claimed thereon, as it would result in allowing the same deduction twice. Interest paid by a corporation constitutes a separate deduction and should not be taken into account as a part of the cost of manufacture.[4]

Business Expenses. Business expenses include all items entering into what is ordinarily known as the cost of goods sold, together with selling and management expenses. Among the items to be treated as business expenses are material, labor, supplies and repairs in the case of a manufacturer, while a merchant would include his purchases of goods bought for resale. In either case the amount to be taken as a deduction in any year should be determined by taking into consideration the inventory at the beginning

operation of the business and properties of the corporation, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken, or is not taking, title or in which it has no equity." (Revenue Act of 1916, § 12 (a).) In the case of non-resident aliens the deduction was limited to business conducted within the United States and in the case of foreign corporations to business and property within the United States.

4 T. D. 2137.

and end of the year. Other items that may be included as business expenses are reasonable compensation for the services of officers and employees, advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident or other similar losses in the case of a business, and rental for the use of business property. A taxpayer is entitled to deduct the necessary expenses paid in carrying on his business from his gross income from whatever source.[5]

Expenses of Operation. Expenses of operation[6] were held under the 1916 Law to include all expenditures for material, labor, fuel, and other items entering into the cost of the goods sold or inventoried at the end of the year, and all other expenses incurred in the operation of the business, except such as were required by the act to be segregated in the return,[7] or had been considered in determining the cost of purchases during the year. Payments for labor and materials which go into the actual operating of a railroad and its properties were deductible.[8]

Cost of Manufacturing Products. One engaged in manufacturing might, under the 1916 Law, include as an element of the cost of manufactured products, the cost of raw material, the cost of labor of the men who actually work on such products as well as the cost of supervisory labor such as that of foremen, inspectors, overseers, etc., provided such expenditures were not separately deducted from gross income in the return of annual net income.[9] This

[5] Reg. 45, Art. 101.

[6] The 1916 Law permitted the deduction by corporations of "all the ordinary and necessary expenses paid * * * in the maintenance and operation of its business and properties." The 1918 Law permits the deduction by corporations of "all the ordinary and necessary expenses paid * * * in carrying on any trade or business," which seems to be a broader phrase than that used in the 1916 Law. (Compare Revenue Act of 1916, § 12 (a) with Revenue Act of 1918, § 234 (a) 1.)

[7] Reg. 33, Art. 114.

[8] Grand Rapids etc. Ry. Co. v. Doyle, 245 Fed. 792, T. D. 2210.

[9] T. D. 2152.

ruling permits certain items of wages and salaries to be included in the cost of the manufactured product, or to be separately listed as labor, wages, commissions, etc.

Cost of Materials. Taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only to the amount that they are actually consumed and used in operation during the year for which the return is made, provided that the cost of such material and supplies has not been taken into account in determining the net income for any previous year.[10] If a taxpayer carries materials or supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, it will be permissible for the taxpayer to include in his expenses and deduct from gross income the total cost of such supplies and materials as were purchased during the year for which the return is made, provided the net income is clearly reflected by this method.[11]

Commissions. Commissions paid to a real estate agent for collecting rents and managing property are allowed as a business expense to the owner. Commissions paid to salesmen as a part of the expense of conducting business are also allowed as deductions.[12] Commissions paid in purchasing and selling securities are a part of the cost or selling price of the securities and not otherwise deductible. They do not constitute expense deductions in a return of income.[13]

COMMISSIONS PAID IN STOCK. Commissions allowed to salesmen, paid in stock, are deductible as an expense, if so charged on the books, at the actual value of such stock.[14]

Entertainment Money. So-called spending or treating money actually advanced by business enterprises to their

10 Reg. 33 Rev., Art. 130.
11 Reg. 45, Art. 102.
12 T. D. 2090.
13 Reg. 33 Rev., Art. 8.
14 Reg. 33, Art. 117.

traveling salesmen, as a part of the selling expense of their product, is a proper deduction. There must, however, be some showing that all of the allowance claimed as a deduction was actually expended for the purpose for which the allowance was made, namely, the selling of the product in question.[15]

Contributions for Campaign Expenses. Contributions for campaign expenses and sums of money expended for lobbying purposes, are held not to be ordinary and necessary expenses of corporations and are therefore not deductible.[16]

Customs Duties. Customs duties may be either deducted as taxes or may be included as a part of the cost price of the goods, if the taxpayer is engaged in the importation of goods and merchandise.[17] Such duties of course should not be both included as cost of the goods and deducted as taxes.

Discounts. Discounts, other than bank discounts on notes executed by a corporation, were required, under the 1909 Law, to be segregated from the interest item on the return and to be included under expenses.[18]

Reserve for Redemption of Trading Stamps. Where a taxpayer, for the purpose of promoting his business, issues trading stamps or coupons redeemable in merchandise or cash, and sets up a reserve each year to cover all probable redemptions of coupons issued in that year, the reserve so set up may be deducted from gross income as a business expense, provided: (a) that the returns of the taxpayer are otherwise made on an accrual basis; (b) that any income tax and excess profits tax returns of the taxpayer which have been previously made covering the period since March 1, 1913, shall be amended, if necessary, so that deductions for any of such years are made on the

15 T. D. 2090.

16 T. D. 2137.

17 Letter from Treasury Department dated December 22, 1914; I. T S. 1918, ¶¶ 521 and 1454.

18 T. D. 1675.

basis of reserves instead of upon actual redemptions as formerly required; and (c) that no larger amount shall be set up as a reserve for any taxable year than would be required for the redemption of such part of the entire issue of that year as it appears will eventually be presented for redemption. The reserve percentage will be determined by considering the experience of the taxpayer and of other users, taking into account any material differences between the taxpayer's situation and that of other users whose experience is relied on. Taxpayers who submit returns on this basis shall file therewith any amended returns called for by this ruling and shall also attach thereto a statement of the experience of the taxpayer and of any other user of coupons whose experience is relied on to determine the percentage of reserve, indicating the name of such other user, the denominations most largely issued, and the character of business involved in each instance.[19]

Expenses of Maintenance. Maintenance [20] means the upkeep or preserving of the condition of the property to be operated and does not mean additions to the equipment, additions to the property or improvements of former condition of the property.[21]

Improvements. In the case of a railroad where old rails are replaced with new and heavier rails, wooden bridges and culverts with concrete and steel bridges and culverts, the rule is that the cost of renewals with like kind and quality is allowable, but excess cost is not allowable as a deduction.[22]

Repairs. Incidental repairs made to the business property of a taxpayer which neither add to the value of the property nor appreciably prolong its life, but keep it in an

19 Reg. 45, Art. 104; Reg. 33 Rev., Art. 141.

20 See Note 6.

21 Grand Rapids & Indiana Ry. Co. v. Doyle, 245 Fed. 792; T. D. 2210.

22 Grand Rapids & Indiana Ry. Co. v. Doyle, 245 Fed. 792; T. D. 2210.

operating condition, are expense, provided the plant or property account is not increased by the amount of such expenditures.[23] Expenditures for replacing worn out parts such as gears, bolts, nuts, valves, etc., so long as such replacements are not pursued to the extent of, and for the purpose of, finally restoring the machinery or equipment as a whole, constitute incidental repairs and are deductible as operating expenses. In addition, depreciation on the property so repaired may be claimed in order to replace the machinery, equipment or building when, as an entirety, it is worn out or is worthless for the purpose for which it is intended.[24]

Office Furniture and Equipment. An ordinary amount expended for renewal of office furniture and equipment, and charged to expense, was held not to be invested in assets, but to be a proper expense of maintenance of the business of an insurance company, which it was entitled to deduct in ascertaining its taxable net income under the 1909 Law. The company had expended in one year $1,213 for ordinary renewals of office furniture, in another year $1,379, and an additional sum of $1,808 for ordinary renewals of attendants' uniforms, door mats, window shades, awning, small hardware, oils and other articles of like character and also the sum of $2,244 for ordinary renewals of office equipment, consisting of lamps, alterations of fixtures, shades, meters, fans, plugs, wirings, etc., and these expenditures were no greater than the average of similar expenditures for other years and did not exceed 5% of the cost of all the plaintiff's existing furniture and equipment similar to the articles detailed, and none of the items was considered in the corporation's books or statement as assets because of their rapid depreciation. It was held that the articles mentioned were of a perishable and transient nature, and properly charged to expense of maintenance, since they apparently did no more than maintain in proper condition

[23] Reg. 33, Art. 131; Reg. 45, Art. 103.

[24] Reg. 45, Art. 103; letter from Treasury Department dated September 19, 1916.

and repair the ordinary equipment of office furniture and supplies.[25]

Expenditures for Alterations. In the case of a company which expended approximately $5,000 for alterations in its home office, apparently solely with a view of facilitating the carrying on of its business, it was held under the 1909 Law that such amount was properly deducted as an expense. The Court said in part: "It should be remembered, also, that in these days of up-to-date business method requirements it often becomes necessary for business concerns to change the lay-out and appointments of the places wherein they carry on business, with a view to economy in space, a saving of unnecessary labor, and the bettering of working conditions of employees, to the end that a net saving of running expenses will result. In view of the consistent expansion of the plaintiff's business, which the evidence shows, it would seem that the amount expended for the changes made in the office ought not, under the circumstances, to be considered unreasonable or unusual, and that, therefore, the amount claimed might well have been allowed as an item of deduction. It seems to the court that business concerns, in matters of this kind, should be allowed a reasonable discretion, and the law so enforced as to help rather than to hinder them in making reasonable progress in the development of their business, for it must appear to anyone giving the matter a moment's consideration that the more successful a business the larger the results, even from the standpoint of taxes accruing to the government."[26]

Payment in Lieu of Rental. Where a leasehold is purchased and paid for in one sum at the beginning of the lease the amount so paid may be divided by the number of years constituting the life of the lease and a deduction

25 Mutual Benefit Life Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918.

26 Connecticut Mutual Life Ins. Co. v. Eaton, 218 Fed. 206.

made annually of a proportionate amount, such item to be claimed as a payment made in lieu of rental.[27]

Rent for Residential Property. In the case of a pro fessional man who rents property for residential purposes but receives there clients, patients, or callers in connection with his professional work (his place of business being elsewhere) no part of the rent is deductible as business expense.[28]

Repairs and Improvements Made by a Tenant. Where a lease requires the tenant to make all necessary repairs or improvements, which repairs or improvements revert to the landlord at the expiration of the lease, the tenant may charge the cost of all such repairs and improvements to the expense of doing business. If the improvements are somewhat permanent in character, the expense should not be all deducted in one year, but should be pro-rated over the number of years constituting the term of the lease, and the amount deductible from gross income of each year would be the aliquot part of such cost.[29] Taxes or other expenses paid by the tenant for the landlord should be deducted by the tenant as expense.

Cost of Buildings Erected by Tenant Under Terms of Lease. Where, under the terms of a rental or lease contract, a tenant agrees to erect a building, or to expend during the rental period a certain fixed sum in making improvements upon the freehold, the building or permanent improvements become a part of the realty, unless otherwise agreed upon between the contracting parties. As the use of the building or permanent improvement by the tenant, during the term of the lease, is a part of the consideration of the contract, the cost of such buildings or improvements may be pro-rated by the tenant over the leased term and be deducted, at an annual rate, as a part of the necessary expenses actually paid in carrying on any busi-

[27] Letter from Treasury Department dated February 27, 1917; I. T. S. 1918, ¶ 1506.

[28] Reg. 33 Rev., Art. 8.

[29] T. D. 2137.

ness or trade. The tenant may also deduct the cost of incidental repairs and maintenance to such buildings and improvements.[30] If the building is erected, or permanent improvements are made after the lease is partially expired, the cost thereof may be divided by the number of years the lease then has to run, and if the life of the lease is longer than the estimated life of the building or improvements, the cost may be divided by the number of years such building or improvements are expected to last, instead of the number of years constituting the life of the lease.[31]

Insurance Premiums. Where premiums are paid for insurance on property used for business purposes, or rented or leased to secure an income, the amount so paid constitutes an allowable deduction.[32]

LIFE INSURANCE PREMIUMS. Premiums paid on any life insurance policy covering the life of any officer or employee or any person financially interested in any trade or business carried on by a taxpayer directly or indirectly a beneficiary under such policy may not be deducted as a business expense.[33]

PREMIUM ON FIDELITY BOND. Where an employee is required to furnish a bond and pay the premium thereon, as a necessary incident to his employment, the amount so paid

30 T. D. 2442. Reg. 33, Art. 115.

31 Letter from Treasury Department dated February 27, 1917; I. T. S. 1918; ¶ 1506.

32 Reg. 45, Art. 101; T. D. 2090.

33 Revenue Act of 1918, §§ 215, 235. It was held by the Treasury Department that the corresponding provision of the 1916 Law, as amended (Revenue Act of 1916, § 32, added by Revenue Act of 1917), applied to all forms of life insurance, the premiums upon which the individual, partnership or corporation might pay, whoever might be the beneficiaries. (Reg. 33 Rev., Art. 236.) Prior to the passage of this provision it was held by the Treasury Department that such premiums were deductible (T. D. 2090). This ruling was subsequently reversed and it was held thereafter that premiums were not deductible (T. D. 2519, dated August 30, 1917). It seems, from the language of this latter Treasury Decision, that it was not intended to have a retroactive effect for years prior to 1917.

may be deducted by him as an expense.[34] If the employer pays the premium it may be included in his business expense.

RESERVES FOR INSURANCE. Funds set aside by a corporation for insuring its own property are not a proper deduction as a business expense, but any loss actually sustained may be deducted, although actually paid out of a fund sc set aside.[35]

Salaries. The 1916 Law did not expressly mention "salaries" in the provisions allowing the deduction of business expenses.[36] The 1918 Law expressly authorizes the deduction by employers of "a reasonable allowance for salaries or other compensation for personal services actually rendered."[37] This provision seems to authorize the Commissioner to disallow such part of salary deductions as appear unreasonable in view of the services rendered, notwithstanding that the salary may actually have been paid under a valid contract. The rulings hold the test of deductibility to be whether in fact payments of salaries are purely for services or include "*some other element.*" In the case of any compensation, however determined, which exceeds amounts ordinarily paid for like services in like enterprises under like circumstances, the burden is upon the taxpayer to show that the amount paid is solely the purchase price of services. In cases, however, where the compensation, on whatever basis fixed, represents only the price paid for services pursuant to a fair bargain made in advance between the individual and the business enterprise, such compensation is deductible, even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.[38]

SALARY FIXED AFTER SERVICES RENDERED. It was held under the 1916 Law that reasonableness was ordinarily the

34 T. D. 2090.
35 Reg. 33, Art. 122.
36 Revenue Act of 1916, § 5 (a) and § 12 (a).
37 Revenue Act of 1918, §§ 214 (a) and 234 (a).
38 T. D. 2696, Reg. 45, Art. 105, 106.

controlling test of the deductibility of salaries determined after services had been rendered. In certain instances apparently of this sort it was permitted to be shown that the compensation was fixed according to a custom or practice having virtually the force of a contract. Where this was not true and it was for the management to fix a fair compensation it was assumed that true compensation was only such amount as would ordinarily be paid in like circumstances by similar enterprises; in other words, that the fair criterion was what the recipient could get by rendering the same services to another employer.[39]

SALARIES CONSTITUTING A DISTRIBUTION OF DIVIDENDS. Any amount paid in the form of a salary, but not in fact as the purchase price of services was not deductible. In the case of corporations, a salary paid to an officer or employee who was not a stockholder was a proper deduction if it fulfilled the requirements stated in the preceding paragraph. Where the officer or employee was also a stockholder, the salary deduction was subjected to closer scrutiny. An ostensible salary may be a distribution of a dividend on stock, especially in the case of a corporation having a few stockholders, practically all of whom draw salaries.[40] It was first held that the following rules should be observed in connection with such payments: (a) the services must be actually performed, (b) the amount must be no more than a fair and reasonable compensation for services rendered, and (c) the compensation should not depend upon the interest of the officer or employee in the corporation as a stockholder or vary from year to year with the earnings of the corporation.[41] It was later held that if in such cases

39 Id.

40 Id.

41 T. D. 2152; letter from Treasury Department dated February 2, 1915; I. T. S. 1918, ¶¶ 1389 and 1811. Under the 1909 Law it was held that in addition to the rules stated in the text, it was necessary that the salary paid to an officer who was a stockholder should be authorized by the board and made a matter of record on the minute book of the corporation, in order to be an allowable deduction. T. D. 1742.

salaries were based upon or bore a close relation to the stockholdings of the officers or employees, the salaries, if in excess of those ordinarily paid for similar services were not paid wholly for services rendered, but in part as a distribution of earnings upon the stock. The amount of the excess was required to be treated as dividends and was therefore exempt from the normal tax and from the excess-profits tax in the hands of the recipient.[42] Where a company was composed of two stockholders who divided the net profits between them, calling it compensation, it has held by the courts that the money paid out was equivalent to a dividend and must be treated as such.[43]

SALARIES CONSTITUTING A WASTE OF ASSETS. An ostensible salary paid by a corporation may be in part a waste or appropriation of assets of the corporation, especially where salaried employees are in control of the corporation through holding, directly or indirectly, a majority of its stock. In the case of a large corporation with many stockholders owning a substantial minority of its stock the tendency of officers unduly to inflate their salaries must be taken into account. In such cases payments representing a waste or appropriation of assets of the corporation by officers who control it and fix their compensation in violation of the rights of the corporation were held not to be deductible to the amount of their excess over a reasonable compensation. While disallowed as a deduction to the corporation such payments were required to be treated as compensation of the individuals, subject to the normal and excess-profits taxes, compensation illegally secured being none the less subject to tax in all respects. If a compensation contract with the

42 T. D. 2696. See also Reg. 33, Art. 119. It is conceivable, of course, that an individual may render services of great value to a corporation of which he is the chief stockholder and it seems reasonable that he should be entitled to compensation for services he actually performs in addition to his dividends as a stockholder since as a stockholder he is under no duty to devote any part of his time to the business of the corporation.

43 Jacobs and Davies, Inc., v. Anderson, 228 Fed. 505; T. D. 2262.

majority stockholder or stockholders was approved by all the stockholders, as well as by the directors, it might however be dealt with like any other contract.[44]

SALARIES CONSTITUTING PART PAYMENT FOR PROPERTY. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business. It was held that under the 1916 Law such salaries, insofar as they constitute payment for the transfer of a business, should be treated by the corporation as a capital expenditure and by the recipient as part of the purchase price.[45]

SALARIES PAID TO ENLISTED MEN. An individual, partnership or corporation continuing to pay an officer or employee his salary or compensation, or part thereof, while he serves in the United States Army or Navy or while he has undertaken services for the Government at Washington or elsewhere at reduced or nominal compensation, is permitted to deduct the amount as an expense, on the theory that the business purpose of the continuance of such compensation is to preserve the organization and secure the return after the war of such officers or employees.[46]

ALLOWANCES TO MINOR CHILDREN. The father is legally entitled to the service of his minor children. Allowances which he gave them, whether said to be in consideration of service or otherwise, were not, as a rule, allowable deductions, under the 1916 Law, nor were they income to the children.[47]

Bonuses and Profit Sharing Payments. The rules and

[44] Reg. 45, Art. 106, T. D. 2696.

[45] Reg. 45, Art. 106, T. D. 2696.

[46] T. D. 2660; letter from Treasury Department dated October 4, 1916; I. T. S. 1918, ¶ 1391.

[47] Reg. 33 Rev., Art. 8.

regulations[47a] issued under the 1916 and former laws in regard to the deductibility of special payments made as extra compensation to officers or employees of an enterprise,[48] do not permit of a ready determination of every question,[49] but indicate an increasing liberality on the part of the Treasury Department toward the allowance of such payments as deductions. All such payments to officers or employees having any considerable interest in the profits of the enterprise through stock ownership or otherwise are subject to careful analysis in the same manner as salaries. The scope of this scrutiny has been treated in the foregoing paragraphs. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Just as in the case of salaries the test is whether the payments are in fact purely for services or include "some other element." Generally speaking, if contingent compensation is paid pursuant to a friendly bargain between the enterprise and the individual, made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing fair and advantageous terms, the contingent compensation should be allowed as a deduction, even though in the final working out of the contract it may

[47a] T. D. 2696; T. D. 2616; T. D. 2152; T. D. 2090; Reg. 33 Rev. Arts. 8 and 138; letter from Treasury Department dated June 25, 1914; I. T. S. 1918, ¶ 1398; Mimeograph letter to Collectors No. 1314, I. T. S. 1918, ¶ 1401; letter from Treasury Department dated November 12, 1917; I. T. S. 1918, ¶ 1407.

[48] The later rulings treat the question irrespective of the status of the payor of the bonus, establishing the same rule, so far as deductibility is concerned, in the case of individuals, partnerships and corporations. The term "enterprise" is used in the text to include all these three forms of business activity.

[49] They are said "to indicate a basis of solution" when applied "in the light of full knowledge of the facts in the particular case." (T. D. 2696.)

prove to be greater than the amount which would ordinarily be paid. Reasonableness is ordinarily the controlling test of the deductibility in the case of bonuses and special compensation for services, as in the case of salaries. Summarizing the latest ruling[50] the following rules may be stated as a basis for the determination of the question whether special payments made as extra compensation to officers and employees of an enterprise are deductible under the heading of business expenses: (a) the fundamental test is whether or not such payments are made as compensation for services rendered; (b) if payments of compensation for services rendered are made in pursuance of a contract express or implied (which need not be in writing)[50a] or a long-time practice (practically an implied contract), regularly employed, of paying to employees certain sums in addition to their stipulated salaries, constituting a condition, if not a contract, whereby the employees may reasonably expect for greater or better service rendered, additional pay, they are deductible; (c) if payments are made as compensation for services rendered, but not in pursuance of a contract expressed or implied or a long-time practice as above stated, the total amount of salary and extra compensation may not exceed a reasonable compensation for the services rendered. The early condition that payments of bonuses or extra compensation could not be dependent upon the earnings of the paying corporation no longer obtains except in so far as may throw light upon the question of whether or not the payments in question are made as compensation for services rendered.[51]

50 Reg. 45, Art. 107; T. D. 2696.

50a A written contract is, of course, better evidence in case any question arises.

51 The early rulings held in effect that payments made by a corporation as extra compensation to officers and employees might be deducted: (a) if it was clearly shown that they were made as compensation for services rendered; (b) if they were paid in pursuance of a contract express or implied; (1) the contract need not have been in writing, (2) a long time practice (practically an implied contract), regularly employed, of paying to employees certain sums in addi-

GIFTS OR GRATUITIES TO EMPLOYEES. Gifts or gratuities made by an enterprise to its employees are not proper deductions under the heading of expense. Even where such payments are called extra compensation, if they are in fact gratuitous or voluntary payments for which no services are rendered, their character as gifts is not changed. The custom of paying bonuses or Christmas gifts to employees, even though it has been the practice of the enterprise for a long time to make such gifts, does not render the amount so paid a proper deduction as expense if the gift is purely voluntary and gratuitous.[52] On the other hand, it would seem that so-called Christmas gifts may be deductible if they fulfill the requirements stated in the preceding paragraph.

PENSIONS. Amounts paid as pensions to retired employees, or their families, or others dependent upon them, or paid on account of injuries received by employees, are ordinary and necessary expenses, but where the salary of an employee is paid for a limited period after his death to a relative or dependent, in recognition of the services rendered by the employee, no service being rendered by the recipient, the payment is a gratuity and not an expense of the business.[53] This deduction was allowed or disallowed upon the basis of the general provisions[54] of the 1916 Law permitting the deduction of the necessary expenses of individuals in carrying on any business or trade

tion to their stipulated salaries constituted a condition if not a contract, whereby the employees might reasonably expect, for greater or better services rendered, additional pay and was equivalent to a contract within this heading; (c) if the total amount of salary and extra compensation was not greater than a reasonable compensation for the services rendered, (d) if they were not conditional upon the earnings of the corporation but were conditional or dependent upon the services rendered. (See note 47a.) These tests were later modified, as indicated in the text above.

[52] See T. D. 2090; T. D. 2152; Mimeograph letter to Collectors, No. 1314; I. T. S. 1918, ¶ 1407. See Reg. 45, Art. 107.

[53] T. D. 2090.

[54] Revenue Act of 1916, §§ 5 (a), 12 (a).

and the ordinary and necessary expenses of corporations paid in the management and operation of its business and properties. The Revenue Act of 1918 expressly provides [55] that these expenses include "a reasonable allowance for salaries or other compensation for personal services *actually* rendered." But the intent is probably not to exclude pensions paid by reason of services which have been rendered. No deduction can be made for contributions to a pension fund the resources of which are held by the corporation, the amount deductible in such case being the amount actually paid to the employees.[56]

Donations. Donations by business concerns may or may not be held to be proper deductions as expense. There must be a consideration in some form to take the donation out of the class of gratuities. When a donation legitimately represents a consideration for a benefit flowing, directly or indirectly, to the donor, as an incident of its business, it is an allowable deduction. It has been held that a corporation engaged in the agricultural business cannot be allowed to make deductions on account of donations to fairs, churches, and associations; such donations, although made for the purpose of obtaining and preserving the good will of the farmers, being mere gratuities. Where a street railway company donates a sum of money to an organization intending to hold a convention in the city in which the company operates, with the expectation that the holding of such convention will augment its income because a greater number of people will use its street cars, the donation has been held to be deductible. A donation to a hospital, under agreement that employees of the donor are to have a ward for their use in case of accident or illness, is a proper deduction. Donations made for purposes connected with the operation of the business, when limited to charitable institutions, hospitals or educational institutions, conducted for the benefit of employees

[55] Revenue Act of 1918, §§ 214 (a) 1, 234 (a) 1.
[56] Reg. 33 Rev., Art. 136.

or their dependents, are within this class, but such donations should be reduced by any amount repaid to the corporation by the employees. Red Cross donations are not within the class.[57]

Farmers. The business expenses allowable as deductions in the case of farmers are fully discussed in another chapter.[58]

Public Utility Under Contract with a State. In the case of a public utility acquired, constructed, operated or maintained under any contract with any city, state or territory or the District of Columbia, where a portion of the net earnings of such public utility is payable, under the contract, to the state, territory, etc., the amount so paid may be deducted by the public utility operating under such a contract as an expense of its business.[59] This deduction is allowed under an express provision of the statute.[60]

57 Reg. 33 Rev., Art. 134; letter from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3437; telegram from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3436.

58 See Chapter 19 on Farms and Farming.

59 T. D. 2090.

60 Revenue Act of 1918, § 213 (b) 7. See Revenue Act of 1916, § 11 (b).

CHAPTER 28

DEDUCTION OF INTEREST

The Revenue Act of 1918 provides that citizens and residents and domestic corporations may deduct all interest paid or accrued within the taxable year on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from taxation as income to the taxpayer. Non-resident aliens and foreign corporations may deduct that proportion of such interest which the amount of his or its gross income from sources within the United States bears to the amount of his or its gross income from all sources within and without the United States.[1] But this deduction is allowed to a non-resident alien only if he files a true and accurate return of his total income from all sources, corporate or otherwise, in the manner prescribed[2] by the law. The special rules applicable to each of the four classes of taxpayers enumerated above and the extensive changes made by the Revenue Act of 1918 are discussed in the chapters relating to each.[3] In all cases interest upon indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from the income tax to the taxpayer, may not be deducted.

1 Revenue Act of 1918, §§ 214 (a) 2, 234 (a) 2.

2 Revenue Act of 1918, § 217.

3 See Chapters 4, 5, 12, and 14 on Citizens and Residents, Non-resident Aliens, Corporations, and Foreign Corporations respectively.

Indebtedness Incurred or Continued to Purchase or Carry Tax Exempt Securities. Prior to its amendment by the Revenue Act of 1917, it was held under the 1916 Law that interest paid on indebtedness could be deducted regardless of whether or not the indebtedness was incurred for the purchase of bonds, the interest upon which was exempt from taxation. This ruling in effect permitted a double deduction, that is, the interest paid on the money so borrowed could be deducted and the income derived from the money so borrowed and invested could also be deducted. The 1917 Law did not permit the deduction of interest paid on "indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under this title."[4] The Revenue Act of 1918 does not permit the deduction of interest paid or accrued on "indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917) the interest upon which is wholly exempt from taxation under this title as income to the taxpayer."[5] State and municipal bonds are obligations or securities falling within this class, as well as National bonds issued prior to September 1, 1917. Interest on indebtedness incurred for the purchase of Liberty bonds of the second issue (the interest on which is not entirely exempt from the surtax) was held deductible regardless of the limitation contained in the 1917 Law.[6] By the parenthetical clause of the 1918 provision taking obligations of the United States issued after September 24, 1917, out of the exception to the deductibility of interest, the Revenue Act of 1918 makes it clear that interest on indebtedness incurred or continued to purchase or carry Liberty bonds of the second, third or fourth loan will be allowed as a deduction. The extension of the exception to the de-

[4] Revenue Act of 1916, §§ 5 (a), 12 (a), as amended by the Revenue Act of 1917.

[5] Revenue Act of 1918, §§ 214 (a) 2, 234 (a) 2.

[6] T. D. 2541.

ductibility of interest to indebtedness "continued" as well as incurred, and incurred or continued to "carry" as well as to purchase tax-exempt securities should be noted.

Interest Paid Within the Year. The 1909 Law provided for the deduction of "interest actually paid within the year" and it was contended by the Treasury Department that this provision required that the interest should be both accrued and paid within the same year. It was held, however, that interest actually paid within the year although previously accruing should be permitted as a deduction.[7] The 1913 Law provided for the deduction of interest paid within the year by individuals, and "interest accrued and paid within the year" by corporations. In a ruling appearing under that law it was held that in the case of corporations the deduction should be limited to interest which had both accrued and been paid within the same year.[8] The 1916 Law permitted the deduction of interest "paid within the year."[9] The Revenue Act of 1918 permits the deduction of interest "paid *or* accrued within the taxable year."[10] It does not seem essential under these provisions that interest should have accrued or become payable in the year in which it is paid in the case of taxpayers reporting on a basis of cash receipts and disbursements.

Interest Paid or Accrued Within the Year. It will be noted that the Revenue Act of 1918 permits the deduction of interest "paid or accrued" within the taxable year.[11] The term "paid or accrued" is to be construed according to the method of accounting upon the basis of which the

7 Anderson v. 42 Broadway Co., 213 Fed. 777. The Supreme Court in reversing the lower court (239 U. S. 69) did not pass on the question of deducting interest accrued in one year and paid in another.

8 T. D. 1960.

9 Revenue Act of 1916, §§ 5 (a), 12 (a), as amended by the Revenue Act of 1917.

10 Revenue Act of 1918, §§ 214 (a) 2, 234 (a) 2.

11 Revenue Act of 1918, §§ 214 (a) 2, 234 (a) 2.

net income of the taxpayer is computed.[12] Under the 1916 Law corporations keeping books of account on an accrual basis were permitted to deduct interest for the year whether paid or not, when such interest was shown as a charge against accrued income upon the books of account.[13]

Interest Paid by Corporations. The limitations imposed by the 1916 Law upon the amount of interest which might be deducted by domestic and foreign corporations are referred to elsewhere in this book.[14]

12 Revenue Act of 1918, § 200.

13 T. D. 2625.

14 See Chapters 12 and 14 on Corporations and Foreign Corporations respectively.

CHAPTER 29

DEDUCTION OF TAXES

In the case of citizens and residents and domestic corporations the provisions of the Revenue Act of 1918 for the deduction of taxes are the same. Such taxpayers may deduct taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits, and excess-profits taxes; or (b) by the authority of any of its possessions, except the amount of income, war-profits and excess-profits taxes allowed as a credit against the tax of the taxpayer; or (c) by the authority of any State or Territory, not including those assessed against local benefits of a kind tending to increase the value of the property assessed; or (d) by the authority of any foreign country except the amount of income, war-profits and excess-profits taxes allowed as a credit against the tax of the taxpayer. Non-resident aliens and foreign corporations may deduct the taxes included in items (a), (b), and (c) above; in lieu of the taxes included in item (d) above they are allowed to deduct taxes imposed by the authority of any foreign country (except income, war-profits and excess-profits taxes, and taxes assessed against local benefits of a kind tending to increase the value of the property assessed).[1] The deduction of taxes by non-resi-

[1] Revenue Act of 1918, §§ 214 (a) 3, 234 (a) 3. In the case of non-resident aliens and foreign corporations the taxes which might be deducted were limited to those assessed by the United States or its territories or possessions or under the authority of any state, county, school district or municipality or other taxing subdivision of any state, paid within the United States, within the year, except such taxes as were not deductible by any class of taxpayers. (Revenue

dent aliens is only allowed if they file a true and accurate return of income from all sources, corporate or otherwise, in the United States in the manner prescribed by law.[2] In addition to the taxes which are allowed as a deduction against gross income in computing net income, certain taxes are permitted by the Revenue Act of 1918 to be credited against the tax otherwise payable. These credits are also discussed in a chapter following.[3]

Taxes Paid or Accrued Within the Year. Under the 1913 Law and the 1916 Law the provisions for deducting taxes expressly limited deductions to taxes paid within the year. It was held by the Treasury Department that reserves for taxes could not be established as only such sums as were actually paid within the year could be deducted, that is, the aggregate of the amounts actually paid as shown by the cash book.[4] The Revenue Act of 1918 provides for the deduction of taxes "paid or accrued." The term "paid or accrued" is to be construed according to the method of accounting upon the basis of which the net income of the taxpayer is computed.[5]

Taxes Not Deductible. The Revenue Act of 1918 expressly provides that no taxpayer shall deduct (a) income, war-profits and excess-profits taxes imposed by the authority of the United States, (b) taxes assessed against local benefits of a kind tending to increase the value of the

Act of 1916, §§ 6 (a), 12 (b).) For the special rulings applicable to non-resident aliens and foreign corporations see Chapters 5 and 14 on Non-Resident Aliens and Foreign Corporations, respectively.

[2] Revenue Act of 1918, § 217.

[3] See Chapter 33.

[4] Reg. 33, Arts. 156, 158.

[5] Revenue Act of 1918, § 200. See Chapter 34 on Returns. The provision of the 1916 Law allowing individuals and corporations to report on a basis other than that of actual receipts and disbursements, and the rulings by the Treasury Department thereunder, seemed to permit, in the case of individuals or corporations reporting on an accrual basis, the deduction of the amount of taxes accrued on their books or the amounts reserved for the payment of taxes providing such amounts did not exceed the actual liability incurred during the year. (T. D. 2433.)

property assessed, and (c) taxes paid by a corporation pursuant to a so-called "tax-free" covenant contained in its bonds, mortgages, deeds of trust, or other similar obligations; and that non-resident aliens and foreign corporations may not deduct (a) income, war-profits and excess-profits taxes imposed by the authority of any foreign country, and (b) taxes assessed against local benefits of a kind tending to increase the value of the property assessed imposed by the authority of any foreign government.[6] Although income, war-profits and excess-profits taxes imposed by the authority of any possession of the United States, or any foreign country (in the case of citizens or residents or domestic corporations) are not allowed as a deduction; they are allowed as a credit against tax.[7] War-profits and excess-profits taxes imposed by the 1918 Law may be deducted from the net income of domestic or foreign corporations in computing the income tax for the same taxable year. In addition to the above the Treasury Department holds that inheritance taxes are not deductible. Taxes paid by a corporation for its stockholders have been held by the courts not to be deductible.

INCOME AND WAR EXCESS-PROFITS TAXES. Prior to its amendment by the Revenue Act of 1917 it was held under the 1916 Law that the income tax paid on income of one year, whether paid by the taxpayer or withheld at the source, was properly deductible from the net income of the following year.[8] The 1917 amendment, however, provided that the Federal income taxes and the Federal excess profits taxes should not be allowed as a deduction.[9] Although in assessing the income tax the net income embraced in a return under the 1917 Law was credited by the Commissioner with the amount of any excess-profits taxes imposed by Act of Congress and assessed for the same

[6] Revenue Act of 1918, §§ 214 (a) 3, 234 (a) 3.

[7] Revenue Act of 1918, §§ 222, 238.

[8] T. D. 2135.

[9] Revenue Act of 1916, §§ 5, 6, 12 (a), and 12 (b) as amended by the Revenue Act of 1917.

calendar or fiscal year upon the tax payer, and in the case of the member of a partnership, with his proportionate share of such excess profits taxes imposed upon the partnership.[10] The provisions of the Revenue Act of 1918 in regard to the deduction of income, war-profits and excess-profits taxes are set forth in the preceding paragraph.

TAXES ASSESSED AGAINST LOCAL BENEFITS. The taxes contemplated by the law as deductible are those which are paid to defray the expense of running the government. Where the taxpayer pays an assessment for something which will directly benefit him or his property it is not considered to be a tax in the true sense but rather in the nature of an investment in property. The Revenue Act of 1918 expressly provides that taxes assessed against local benefits "of a kind tending to increase the value of the property assessed" shall not be deductible.[11] Taxes paid pursuant to assessments levied by special districts, such as irrigation, reclamation, and drainage districts, for sidewalks in cities, street extension, grading, paving, etc., were held under the 1916 Law and former laws not containing the quoted words to be taxes assessed against local benefits and not allowed as deductions.[12]

TAXES PAID UNDER "TAX-FREE" COVENANTS. Where a corporation pays taxes for its bondholders under stipulations in bonds agreeing to pay the interest in full regardless of any tax which it may be required to withhold or deduct, the amount of taxes so paid on behalf of such bondholders is not a proper deduction by the corporation.[13] The rulings on this point are contained in the chapter on corporations. The bondholder may, however, treat the amount so paid for him as his tax and deduct the same, if it is a tax levied by a state; if levied by the federal government he cannot deduct the amount as the

10 Revenue Act of 1916, § 29, added by Revenue Act of 1917.

11 Revenue Act of 1918, §§ 214 (a) 3, 234 (a) 3.

12 T. D. 2090; Reg. 33, Art. 153.

13 Revenue Act of 1918, § 234 (a) 3. See T. D. 1948. The rulings on this point are contained in Chapter 12 on Corporations.

law expressly prohibits deduction of the federal income tax. On the other hand, the bondholder should report as additional income the amount of tax so paid for him by the corporation.

STATE INHERITANCE TAXES. State inheritance taxes paid by the executor or administrator of an estate of a deceased person, which are provided by law to be deducted from the respective legacies or distributive shares, are not allowable deductions in computing the net income of such estate subject to tax, even though the will contain a direction to pay inheritance taxes out of the residue. An inheritance tax is upon the transfer of the property and not upon the estate of the decedent or upon the executor or administrator, although the latter is required to pay it. In general, taxes paid or accrued within the year imposed by the authority of any State, or otherwise, are limited to those imposed upon the taxpayer and do not include taxes paid by him on behalf of another, even though he is required by law to make such payment. Since, moreover, state inheritance taxes are imposed upon the transfer before the property reaches the legatee or the distributee, and merely diminishes the capital share of the estate received by him, such tax is not imposed upon the legatee or distributee and is not an allowable deduction from his income.[14]

TAXES PAID BY CORPORATION FOR STOCKHOLDERS. Under the statutes of many of the states taxes are assessed against the stockholders of banks, the bank being required to pay the tax on behalf of its stockholders. In such cases it was held, under the 1909 Law, that the bank was not entitled to deduct the amount of taxes so paid as the tax was not a tax upon the bank or upon its property.[15] This rule was continued under the 1913 Law and the 1916 Law, such taxes being held to be against the property of the private stockholders and not against either the cor-

[14] Reg. 45, Art. 134; letter from Treasury Department dated February 10, 1916; I. T. S. 1918, ¶¶ 486, 796 and 1669.
[15] T. D. 1763.

poration or its property.[16] The requirements of a state law that a bank shall pay for the stockholder cannot be construed as authority under which the bank may deduct the tax.[17] Where a statute requires the bank to pay the tax and gives it a lien upon the shares, the bank is not entitled to deduct the tax.[18] Where the statute gives the bank the option either to pay the tax out of its general funds or to collect the same from its stockholders, that fact does not change the character of the tax as a tax against the property of the individual stockholders, and the bank cannot deduct.[19] Even though the state statute makes no provision for recovery from the several shareholders of their proportional part of the amount so paid, the bank cannot deduct.[20] The absence of an express provision in the statute does not show that there is no such right of recovery, or that the intention was for the tax to fall ultimately upon the bank and not upon the stockholders.[21] As a general rule the amounts of taxes so paid by a corporation for its stockholders are not collected from the stockholders, the corporation charging the taxes as an item of expense. Such taxes, however, should be reported by the stockholders respectively as taxes paid by them, according to their proportionate interests in the corporation.[22] The amount of the taxes so paid should also be treated as additional income from the net earnings of the corporation.[23] Where shares of stock are sold after the tax has been assessed, but prior to the time it is paid

[16] The Northern Trust Company v. McCoach, 215 Fed. 991; T. D. 2135.

[17] T. D. 2161.

[18] Eliot National Bank v. Gill, 210 Fed. 833, affirmed 218 Fed. 600; National Bank of Commerce v. Allen, 211 Fed. 743, affirmed 223 Fed. 472, petition to the United States Supreme Court for writ of certiorari denied October 25, 1915.

[19] Northern Trust Company v. McCoach, 215 Fed. 991.

[20] First Nat. Bank v. McNeel, 238 Fed. 559.

[21] Home Savings Bank v. Des Moines, 205 U. S. 503.

[22] T. D. 2135.

[23] See Chapter 23.

by the corporation on behalf of the stockholders, the one holding the stock on the date when a tax became due and payable is the one entitled to report the amount as a dividend and deduct the amount as a tax paid by him.[24]

Taxing Subdivisions of Territories. It was provided by the 1916 Law that "taxes paid within the year imposed by the authority of the United States (except income and excess-profits taxes) or of its Territories, or possessions, or any foreign country, or by the authority of any State, county, school district, or municipality, or other taxing subdivisions of any State, not including those assessed against local benefits" were deductible.[25] No express provision was made for the deduction of taxes imposed by the authority of "any taxing subdivision" of any territory. The Revenue Act of 1918 now provides[26] for the deduction of taxes imposed by a taxing subdivision of any Territory.

Bank Guaranty Fund. Banking corporations which, pursuant to the laws of the state in which they are doing business, are required to set apart an amount, levied and assessed against them by the state authorities, as a "depositor's guaranty fund" may deduct the same from their gross income, provided the fund is set aside and carried to the credit of the state banking board or other duly authorized state officer, and may be withdrawn upon demand by such board or state officer to meet the demands of these officials in reimbursing depositors of insolvent banks, and, provided further, that no portion of the amount so set aside and credited is returnable, under the existing laws of the state, to the assets of the banking corporation. In

[24] Letter from Treasury Department dated February 25, 1916; I. T. S. 1918, ¶ 490. An earlier ruling in a letter dated March 2, 1915, held that the stockholder owning the stock at the time the taxes were assessed was the one entitled to the deduction, but the later ruling referred to above seems to indicate the present attitude of the Treasury Department.

[25] Revenue Act of 1916, §§ 5, 6, 12 (a) and 12 (b), as amended by Revenue Act of 1917.

[26] Revenue Act of 1918, §§ 214 (a) 3, 234 (a) 3.

such cases the amount of the guaranty fund is no longer an asset of the bank, but is in the nature of a tax and as such is deductible.[27] Strictly speaking, such assessments are more properly deductible as an expense of doing business or, perhaps, as a loss, since the fund is intended to meet the losses of the banking business as a whole.

Taxes Paid by a Tenant. Where a tenant pays the taxes on property leased by him, he may consider the amount so paid as an additional payment of rent and may deduct it as an expense of carrying on his business.[28] To the landlord the amount is equivalent to an additional payment of rent and must be reported as such, but he may also deduct the amount, as, to him, it is a tax paid during the year by the tenant as his agent. The transaction is tantamount to a payment of the sum by the tenant to the landlord and a repayment by the landlord to the tenant, as his agent, for the purpose of satisfying the tax.

[27] T. D. 2152.
[28] T. D. 2090.

CHAPTER 30

DEDUCTION OF LOSSES

The Revenue Act of 1918 provides in the case of individuals that in computing net income there may be allowed as deductions, if sustained during the taxable year and not compensated for by insurance or otherwise, (a) losses incurred in trade or business, (b) losses incurred in any transaction entered into for profit, though not connected with the trade or business, (c) losses of property not connected with the trade or business if arising from fires, storms, shipwreck, or other casualty or from theft.[1] The extent to which losses may be deducted by non-resident aliens and foreign corporations and the subject of losses incurred in trade are more fully discussed in previous chapters.[2] Individuals and corporations may also deduct debts ascertained to be worthless and charged off within the taxable year.[3] The rules discussed in this chapter are those applicable to corporations and individuals generally. In the case of corporations all losses sustained during the taxable year and not compensated for by insurance or otherwise may be deducted.[4] The 1918 Revenue Law contains a new provision for the deduction of net losses in certain cases against the income of the preceding year,[5] and also as to losses in inventory ascertained after the close of the taxable year.[6]

1 Revenue Act of 1918, § 214 (a) 4, 5, 6.

2 See Chapters 4 on Citizens and Residents, 5 on Non-Resident Aliens and 14 on Foreign Corporations.

3 Revenue Act of 1918, §§ 214 (a) 7 and 234 (a) 5.

4 Revenue Act of 1918, § 234 (a) 4.

5 See p. 475.

6 See p. 473.

Measure of Loss. In the case of loss of property or assets the loss must be based upon the difference between the cost value or the value as of March 1, 1913, if acquired before that date, and the salvage value of the property or assets, including in the latter value such amount, if any, as has, in the current or previous years, been set aside and deducted from gross income by way of depreciation.[7] When property is sold, the loss is the difference between the selling price and cost or value as of March 1, 1913, if acquired before that date, where the selling price is less than the cost.[8] Losses resulting from the sale or other disposition of property are discussed in a later paragraph of this chapter. In a case arising under the 1909 Law, the court said: "There seems to be no limitation provided in the act as to the amount of deductions to be allowed for losses actually sustained from any source during the year, and whether due to conditions of business, the sale of property, or anything else, and the court must, therefore, assume that the statute contemplated that the full amount of all losses sustained within the year would be allowed."[9]

Losses Must Be Sustained During Year. The 1916 Law provided in the case of individuals that the loss must be "actually sustained during the year" and in the case of corporations that the loss must be "actually sustained and charged off within the year."[10] The Revenue Act of 1918 omits the word "actually" in the case of individuals and the words "actually" and "and charged off" in the case of corporations. The Treasury Department holds that a

[7] Reg. 33 Rev., Art. 147.

[8] Reg. 33 Rev., Art. 147; T. D. 2090.

[9] Connecticut Mutual Life Ins. Co. v. Eaton, 218 Fed. 206. In this case the court required the corporation to report as income all of its profits and permitted it to deduct all of its losses on the sale of property during the year, regardless of the fact that some of the property was purchased prior to the incidence of the tax, it appearing that the result would be the same as if the gains and losses had been pro-rated as then required by the Treasury Department.

[10] Revenue Act of 1916, § 12 (a).

loss to be deductible must be an absolute loss, actually sustained and ascertained during the taxable year for which the deduction is sought to be made. It must be determined and ascertained upon an actual, a completed, a closed transaction. Losses sustained from the sale or dealings in real or personal property growing out of the ownership or use of, or interest in, such property will not be deductible at all unless they are ascertained, determined and fixed as absolute in the above sense within the taxable year in which the deduction is sought to be made.[11] The amount to be deducted as a loss should have in it no element of "depreciation" or "allowance for wear or tear" or "compensation from insurance or otherwise." The amount is to be an absolute and complete loss which has been actually sustained.[12] Under the 1916 Law, in the case of corporations, the loss might not be deducted unless it was actually sustained during the year and charged off on the books.[13] This rule seemed to apply with equal force in the case of an individual who kept books, but one who did not keep books was not thereby deprived by the law of the right to claim a loss, except in the case of worthless debts.

FLUCTUATIONS IN BOOK VALUES. Fluctuations during the year in the value of capital assets, such as securities, even though evidenced by book entries, do not constitute losses actually sustained. A loss may not be deducted until as a result of a completed, a closed transaction, the loss has

11 T. D. 2005. See, however, the special rules at the end of this chapter.

12 T. D. 2005.

13 Under the 1916 Law it was held that a corporation was not entitled to a deduction for a loss unless charged off on the books of the corporation before such deduction was allowed. The statute was not to be construed as requiring that losses be charged off within the taxable year. It was sufficient that they were charged off before they were allowed as deductions. Consequently at the time of an examination of a corporation it was given an opportunity to reopen its books and charge off losses which it had actually sustained during the taxable year. (Letter from Treasury Department dated June 25, 1918; I. T. S. 1918, ¶ 3599.)

been definitely ascertained and the amount it represents has irredeemably disappeared from the assets of the taxpayer.[14] Only dealers in securities may inventory securities at market value.

Reserves for Losses. Reserves to take care of anticipated or probable losses are not a proper deduction.[15] On the other hand, losses sustained during the year may be deducted although it is made good out of a fund which has been accumulated as an insurance reserve by the taxpayer.[16]

Losses of Income. Loss of income is not, generally speaking, a proper deduction. If, for instance, a debtor defaults in payment of interest, or a corporation fails to pay a regular dividend, or an employer fails to pay commissions or salaries, the amount of such items may not be deducted from other income during the year, as the income is reduced by the mere fact that such sums are not included. If, however, the taxpayer has reported any such amounts as income for the taxable year, or a preceding year, as might be done in the case of taxpayers reporting on a basis other than that of actual receipts and disbursements, the subsequent failure to collect the amounts so entered on the books may be treated as a loss when it is determined that the amount is not collectible. This point is discussed in the paragraph below on worthless debts.

Losses of Capital. What the law contemplates as a deduction is the loss of capital, either by the sale of property or by the destruction or disappearance of property. It is, therefore, immaterial in what year the capital was created so long as the loss is sustained in the taxable year. All losses to be deductible, if not sustained in trade or busi-

[14] Letter from Treasury Department dated August 14, 1914; I. T. S. 1918, ¶ 1344.

[15] Reg. 33 Rev., Art. 166; T. D. 2161. Reserves to take care of the depreciation or obsolescence of property used in the trade or business of the taxpayer are permitted as deductions as set forth in Chapter 31 on Depreciation and Obsolescence.

[16] Reg. 33, Art. 122.

ness, must result from transactions entered into for profit,[17] or must be losses of property arising from fires, storms, shipwreck, or other casualty or from theft.

Sale of Capital Stock. Where the capital stock of a corporation is issued for less than par, the amount of discount is not an allowable deduction to the corporation. Such a transaction is purely a capital transaction and the income of the corporation is not directly decreased by reason of the sale of the stock at a price less than its par value.[18]

Amounts Paid to Make Up Profits of Another Corporation Under Agreement. Contracts guaranteeing the payment of dividends or interest of one corporation by another are frequently made between corporations having close business relations. Whether or not amounts paid under such contracts or guarantees may be deducted, as a loss or as an expense of doing business, by the paying corporation has not been determined by the courts in this country. In England such payments have been held properly deductible as sums expended for the purpose of trade.[19] If the pay-

17 Under the 1916 Law it seemed that a deductible loss need not necessarily be one connected with the business or trade of an individual, except in the case of losses resulting from sales or dealings in property, in which case it was expressly provided that such losses must be incurred in his trade or business. The Revenue Act of 1918 seems to intend that losses resulting from such sales or dealings may be deducted not only when connected with his trade or business, but when not so connected, if in transactions entered into for profit.

18 T. D. 2090.

19 Moore v. Stewarts & Lloyds (1906), 8 Fraser 1129. In this case it was observed that the question was one of fact rather than of law. One company entered into agreement with another whereby in return for the right to nominate a majority of directors of the second company the first undertook to pay to the second such sums each half year as might be necessary to make up any deficit in the dividends on the latter's preferred shares. The court said, "If the agreement was entered into with a view to profit, as I think it was * * * then the annual charge to the respondent company is in my view a part of their business outlay or expenditure and is not subject to assessment."

ment is made under an enforceable contract, there seems to be no reason why the amount should not be deducted either as loss or expense. This question would seem under the present law to be covered by the provision for the making of a consolidated return by affiliated corporations.[20]

Losses from Sales of Property. The most frequent deductions for losses are claimed as a result of the sale of property. In such cases the loss occurs when the selling price is less than the cost. This is the converse of gain from the sale of property which is discussed in a preceding chapter.[21] The cost of the property is determined in the same manner whether the transaction results in a loss or a gain and the same rules apply with respect to property acquired prior to March 1, 1913.

Losses from Exchanges of Property. Where property is exchanged for other property, the property received in exchange is treated for the purpose of determining any loss to the taxpayer as the equivalent of cash to the amount of its fair market value, if any.[22] If the property received in exchange has no fixed value or definitely ascertainable market value, it would be difficult to determine the amount, if any, of loss in the transaction and it does not seem that any loss can be claimed by the taxpayer.

Exchange of Stock. The Revenue Act of 1918 provides[23] that "when in connection with the reorganization, merger or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged." Where in such an exchange a person receives for his stock or securities, new stock or securities of a greater par or face

[20] See Chapter 12 on Corporations.
[21] See Chapter 20 on Income from Sales or Dealings in Property.
[22] Revenue Act of 1918, § 202 (b).
[23] Revenue Act of 1918, § 202 (b).

value then a gain is presumed and a method is provided for determining the amount of such gain.[24] No provision is made for determining and allowing the deduction of a loss when the new stock or securities received are of no greater par or face value than those exchanged. It is expressly stated in the law, as quoted above, that in such case no gain or loss shall be deemed to occur from the exchange. Where in a case of merger stockholders of one corporation exchanged their stock for stock of the corporation resulting from the merger and received a par value less than the par value of the old stock, it was held under the 1916 Law that the transaction constituted a sale for income tax purposes, and that a deduction might be claimed for any loss measured by the difference between the value of the old stock on March 1, 1913, (or the cost, if purchased subsequent to that date) and the value at which the same stock was given in exchange for stock of the company resulting from the merger.[25]

Voluntary Payment by Stockholders of Loss of Corporation. Assessments made by a corporation on its capital stock are regarded as an investment of capital and the amounts paid do not constitute allowable deductions to the stockholders.[26] This rule was held to apply in a case where a corporation showed a deficit at the close of the year and the stockholders agreed to make it good by the payment of voluntary contributions.[27]

Issue of Bonds or Equipment Notes Below Par. Where bonds are issued for a price less than par and are redeemable at par, the Treasury Department has held that the loss, which must eventually be sustained on redemption of

[24] Revenue Act of 1918, § 202 (b).

[25] Letter from Treasury Department dated March 9, 1917; I. T. S. 1918, ¶ 1305. See Chapter 16 on Income—In General. Under the 1916 Law such losses were permitted to be deducted in the case of individuals only to the extent that they did not exceed gains from other similar transactions during the year.

[26] T. D. 2090.

[27] Letter from Treasury Department dated February 21, 1916; I. T. S. 1918, ¶ 1291.

the bonds, may be deducted by pro-rating the amount of the discount in accordance with the life of the bond.[28] The intention of this ruling is to allow corporations selling their own bonds at a discount to pro-rate the discount over the life of the bonds and to deduct from gross income each year an aliquot part of the discount, determined in accordance with the number of years which the bonds have to run from the date of issue. If, however, the bonds were issued prior to the incidence of the tax and, at that time, the entire amount of the discount was charged to profit and loss, the issuing corporation may not claim a *pro rata* allowance for such discount for the years subsequent to the incidence of the tax.[29] Charging off the discount prior to the incidence of the tax constitutes a closed transaction and such transaction cannot be re-opened for the purpose of reducing the taxable income of the corporation.[30] Thus where a railroad company sells bonds and equipment notes at a discount in 1906 and the books show that the loss was entirely charged off under the profit and loss account for 1906, and the company in making returns of excise tax for the years 1911 and 1912 failed to deduct the proportionate amount of discount sustained, it has no right to amend its returns and claim a refund of such amount.[31] The court has held that if a loss sustained by a corporation selling its own bonds at a discount is an expense, it will not be paid until the maturity of the bonds and should, therefore, be prorated over the life of the bonds, and not deducted in full in the year in which the bonds were issued.[32] In cases wherein a corporation sells its bonds at a discount and pays a commission for selling, the amount of such discount and commission, together with other expenses incidental to issuing the bonds, constitutes a loss, the aggregate amount of which loss will, for the purpose of an income

[28] Reg. 33 Rev., Art. 150.
[29] T. D. 2161.
[30] T. D. 2137.
[31] Chicago and Alton R. R. Co. v. U. S.; T. D. 2631.
[32] Baldwin Locomotive Works v. McCoach, 221 Fed. 59.

tax return, be prorated over the life of the bonds sold, and the amount thus apportioned to each year will be deductible from the gross income of each such year until the bonds shall have been redeemed. If a corporation having sold its bonds at a discount, the discount having been deducted from gross income, later repurchases or redeems the bonds at a price less than par, the difference between the price at which they are redeemed and their par value will be returned as income.[33]

Purchase of Bonds for Retirement. Where bonds have been issued at par, under the terms of an indenture requiring the corporation annually to purchase and retire a certain number of the bonds, and the corporation is required to purchase such bonds for retirement in the market, the difference between par value of the bonds and the amount paid for the bonds on retirement is deductible as a loss. If the bonds were issued at a premium, the loss to be claimed should be the difference between the price at which the bonds were issued and the price at which they were purchased for retirement, unless the amount of premium received on the original sale of the bonds was accounted for as income in the year in which the bonds were sold, in which case the difference between the par value and the purchase price may be deducted. In the event the bonds were issued at a discount, and the discount was charged against the earnings of the year in which issued, the difference between the par and the purchase price may be deducted as a loss; but if the discount on the bonds was prorated over the life of the bonds and the annual proportion charged against the yearly income, the amount to be charged off, as a loss, should be the difference between the price at which the bonds were issued and the purchase price minus an allowance for the sums that have been charged off annually on account of the prorated discount.[34]

[33] Reg. 33 Rev., Art. 150.

[34] Letter from the Treasury Department dated March 23, 1915; I. T. S. 1918, ¶ 1437.

Bonds Purchased Above Par. Where bonds have been purchased above par it seems, under the present law, that no deduction can ordinarily be made for the loss of the amount of the premium until the bonds are either sold in the market before maturity, or until the principal sum is received at the time of maturity. In either case the losses will be the difference between the amount paid and the amount received. Where, however, a taxpayer reports on a basis other than of actual receipts and disbursements it seems that this sum may properly be deducted in proportionate amounts each year as amortization.[35]

Loss by Destruction or Disappearance of Property. The law expressly provides, in the case of individuals, that the loss arising from fires, storms, shipwrecks, or other casualty, or theft, may be deducted in the year in which the loss is sustained.[36] This kind of loss is allowed to corporations without specific mention, as with respect to corporations all losses are deductible. In the case of non-resident aliens the law permits the deduction of all such losses of property within the United States.[37] In the case of foreign corporations such deductions are allowed only if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of such deductions with respect to sources of income within and without the United States must be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.[38] In all cases the law provides that the deduction may be made only when such losses are not compensated for by insurance or otherwise. The intent seems to be to permit a deduction of the losses to the extent that the taxpayer is not com-

35 This was also the case under the 1916 Law. Under the 1909 Law it was held that where bonds were purchased at a rate above par a proportionate amount of the premium might be deducted each year on account of amortization (T. D. 1727).

36 Revenue Act of 1918, § 214 (a) 6.

37 Revenue Act of 1918, § 214 (a) 6.

38 Revenue Act of 1918, § 234 (b).

pensated by insurance or otherwise. If he is compensated for part of such loss, he may deduct the part for which he is not so compensated. In claiming a loss due to the destruction of property the salvage value of the property must be considered as a partial compensation to be deducted from or not included in the amount claimed as deduction. Further, if depreciation has been claimed from time to time upon the property so destroyed, the aggregate amount of such depreciation allowance should be deducted from the cost of the property in ascertaining the amount of the loss. In this, as in all other cases, the measure of the loss is the difference between the cost of the property and the amount received as compensation. The value of the property at the time of the loss is not intended to be the measure of the loss. The loss will be the difference between the value as of March 1, 1913, or the cost of the property, and the salvage value thereof, including in the latter value the amount, if any, which has been or should have been set aside and deducted in the current or previous years from gross income on account of depreciation and which has not been paid out in making good the depreciation sustained.[39]

LOSS OF LIVE STOCK. Where stock which has been purchased for any purpose, dies from disease or any injury or is killed by order of the federal or state authorities and the cost thereof has not been claimed as an item of expense (as was formerly permitted in the case of stock purchased for resale) farmers not ascertaining their gross income by the inventory method may deduct as a loss the actual purchase price of such stock, less any depreciation which may have been claimed or any insurance or indemnity recovered.[40] Property destroyed by order of the federal or state authorities may also be claimed as a loss.[41] Any loss resulting from the death of stock which has been raised on the farm is not deductible, the cost of raising the same

39 Reg. 33 Rev., Art. 147.
40 Reg. 33 Rev., Arts. 4 and 123; Reg. 45, Art. 145.
41 T. D. 2665.

having been deducted as an item of annual expense.[42] The rules with respect to the deduction of the loss of live stock by farmers ascertaining their gross income by the inventory method is set forth in another chapter.[43]

SHRINKAGE OR DETERIORATION IN STORAGE. Loss due to shrinkage or deterioration of produce in storage is not allowed as a deduction. Such shrinkage or deterioration is reflected in the selling price when the goods are sold and correspondingly reduces the net income at that time.[44]

WORTHLESS STOCK. A loss is none the less actual because an individual cannot divest himself of the possession of worthless stock by sale, but that condition alone does not give the loss in question such a character as appears to the Treasury Department to have been contemplated by the income tax law.[45] However, if the stock has even the slightest value so that it may be sold for any amount it seems the loss may be deducted, as it is then the result of a closed transaction. It seems, also, that the loss would be properly deductible if the corporation has been dissolved, or if its charter has been forfeited, since then there is a final ascertainment of the loss.

DISTRICT IRRIGATION BONDS. District irrigation bonds as a rule, if not always, are a lien upon the real estate affected by the irrigation project and until the corporation has taken such steps as are necessary to protect its rights and enforce the collection of the bonds, it does not appear that the corporation would be warranted in writing out of its assets and deducting from income, as a loss, the face value or any other arbitrarily ascertained amount representing a loss or shrinkage in the value of such bonds.[46]

Worthless Debts. The Revenue Act of 1918 provides that individuals and corporations may deduct debts ascertained to be worthless and charged off within the taxable

[42] Reg. 33 Rev., Art. 4.
[43] See Chapter 19 on Income from Farming.
[44] T. D. 2153; Reg. 45, Art. 145.
[45] T. D. 2135.
[46] T. D. 2152.

year.[47] For the purpose of deduction as losses, debts are divided into two classes, (a) those which represent to the creditor a return of capital and (b) those which represent unpaid income. The former may be deducted regardless of when the debt became due and payable, but the latter, such as uncollected wages, salaries, rents, interest and items of similar taxable income, may not be deducted, if the debt became due on or after March 1, 1913, unless the amount thereof has been reported as income; but if the debt became due and payable prior to March 1, 1913, it may be deducted in any event.[48] The losses which may be deducted are losses of capital; income on which the tax has been assessed assumes the status of capital, and income which became due and payable before the incidence of the tax is capital to the taxpayer, although it may be received thereafter. The mere failure to receive income does not warrant a deduction, as the omission of such amounts operates, in itself, as a reduction of tax.

MUST BE CHARGED OFF ON BOOKS. The Revenue Act of 1918 expressly provides that in the case of both individuals and corporations worthless debts must have been "charged off" in the year in which they are claimed as a deduction.[49]

WHEN DEBTS MAY BE CONSIDERED WORTHLESS. To determine whether or not a debt is worthless it is not essential that an unsatisfied judgment shall exist or a judicial determination be reached or that the bad debt or account shall be proved worthless by legal proceedings before the deduction may be allowed. The taxpayer must, however, not only be satisfied that the debt or account is worthless, but must be able to satisfy the Commissioner or Collector that the accounts charged off were definitely determined at the time to be worthless and that they had not been recognized as worthless or without value prior to the beginning of the year for which the return is made.[50] If the debtor

47 Revenue Act of 1918, §§ 214 (a) 7 and 234 (a) 5.
48 T. D. 2224.
49 Revenue Act of 1918, §§ 214 (a) 7 and 234 (a) 5.
50 Reg. 33 Rev., Art. 151.

is a corporation, possessed of assets, the debt cannot be claimed as a deduction except for the year in which the debtor corporation's affairs are finally closed and its receiver in bankruptcy discharged. Where an indebtedness is claimed and contested and a settlement is had by way of compromise whereby an amount, less than the debt claimed, is accepted in full payment and satisfaction of the debt, the difference between the amount paid and that claimed is not allowable as a deduction for worthless debts. If the settlement in compromise consists of a promise to pay an amount less than the debt claimed, an accord and satisfaction is established and the amount promised to be paid forms the basis of a new transaction. Upon the breach of this promise the question will arise as to the deductibility of the new amount only.[51] Whenever the debtor is legally discharged from his obligation either by the running of the statute of limitations, by bankruptcy proceedings, by accord and satisfaction, by formal release, or by any other method, it seems that the creditor may claim the amount of loss sustained as a deduction. As indicated by the ruling above, it may be possible under other conditions to deduct the amount of a debt but the circumstances must be such as to indicate beyond doubt that the debt cannot be collected. Where all of the surrounding and attendant circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would not in all probability result in the satisfaction on execution of a judgment, a showing of these facts will be sufficient showing of the worthlessness of the debt for purposes of deduction.[52] A mere voluntary forgiveness of the debt would not make the amount thereof an allowable deduction, since such voluntary action on the part of the creditor would be tantamount to a gift.

FORECLOSURE OF MORTGAGES. Where, under foreclosure,

[51] Reg. 33 Rev., Art. 8. This regulation reversed the Treasury Department's previous ruling that the unpaid portion of a compromised debt might be claimed as a deduction.

[52] Reg. 33 Rev., Art. 8.

a mortgagee buys in the mortgaged property and credits the indebtedness with the purchase price the difference between the purchase price and the indebtedness will not be allowable as a deduction as a bad debt. The property which was security for the debt, being in possession and ownership of the mortgagee, is held for the purposes of income tax, to be sufficient to justify a disallowance of a claim for bad debt. The determination of loss in such a situation is deferred until the property is disposed of. Only where a purchaser for less than the debt is another than the mortgagee may the difference between the debt and the net selling price credited be deducted as a bad debt.[53] A purchaser of accounts receivable which cannot be collected and are consequently charged off the books as bad debts is entitled to deduct them, the amount of the deduction to be based upon the price he paid for them and not upon their face value.[54]

Loss Due to Adverse Judgment. In a case where a corporation was sued for infringing a trade name covering a period ending in 1912, and judgment was obtained against it in 1916, the Treasury Department held that the amount of this judgment should be prorated over the period ending in 1912 according to the income of each year. Such part as was found by this method to be applicable to the income of the corporation for the period 1909 to 1912 would be referable to those years, but no part of this sum would be deductible as a loss in the return of income for 1916. The same corporation also paid, in 1916, an additional sum, as consideration for dismissal of a pending suit for interest on the above judgment from the date of the decision of the court to the date of payment and for the unrestrained use of the trade name in question. It was held by the Treasury Department that if this amount could be segregated between interest and use, it might be prorated the same as in the other case, for the period subsequent to 1912, and

53 Reg. 33 Rev., Art. 8.
54 Reg. 45, Art. 152.

such part thereof as would be found applicable to the 1916 income would be deductible under the heading of business expense and interest respectively. If no segregation could be made the entire amount might be treated as business expense.[55] This ruling was made, apparently, on the theory that the loss was not sustained in 1916, but in the respective years when the income was earned, but the language of the law better supports a conclusion that the entire loss was sustained in the year the adverse judgment was rendered, and it is now held that amounts paid pursuant to judgment or otherwise on account of damages are deductible from gross income in the year and to the extent such amounts are actually paid, less any amount of such damages as may have been compensated for by insurance.[56] If on suit for damages the amount recovered is less than the damage sustained or less than an amount necessary to make good the damage, the difference between the actual amount of damage sustained and the amount recovered will be deductible as a loss by the judgment creditor or prevailing party.[57]

Cost of Drawings, Models and Patterns. Expenditures made for designs, drawings, patterns or models representing work of an experimental nature should be treated as a capital disbursement and not as an expenditure if the designs, drawings, patterns or models prove to be satisfactory and result in the production of salable goods. If, however, they prove to be unsatisfactory and have no asset value, the expenditure may be charged off as a loss incident to running the business and as such deducted from gross income, provided that the taxpayer taking credit for such expenditures in the income tax return makes a full and complete explanation with respect to the same to the satisfaction of the Commissioner.[58] If designs, drawings, pat-

[55] Letter from Treasury Department dated February 9, 1917; I. T. S. 1918, ¶ 1427.

[56] Reg. 33 Rev., Art. 158

[57] Reg. 33 Rev., Art. 94.

[58] Reg. 33 Rev., Arts 175 and 176.

terns, or models result in the production of goods which prove to be salable for a certain length of time and then become obsolete and can not be sold, the amount expended for such designs, drawings, patterns, or models, less any amounts previously claimed as depreciation with respect to the same or as a return of capital, may when charged off, be included in, and deducted as a loss incident to running the business, provided full and complete information is reported in a manner satisfactory to the Commissioner.[59]

Losses Ascertained in 1919 Deductible from Net Income of 1918. The Revenue Act of 1918 contains a new provision regarding losses sustained after the close of the taxable year 1918. It is provided that a taxpayer may file, at the time of filing return for the taxable year 1918, a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by the claim is not required until the claim is decided, but the taxpayer must accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the Commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim is disallowed, the remainder of the tax due must, on notice and demand by the collector, be paid by the taxpayer with interest at the rate of one per centum per month from the time the tax would have been due had no such claim been filed. If it is shown to be satisfaction of the Commissioner that such substantial loss has been sustained, then in computing the income tax the amount of such loss will be deducted from the net income. Where no such claim is

59 Reg. 33 Rev., Art. 177.

filed, but it is shown to the satisfaction of the Commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described, the amount of such loss will be deducted from the net income for the taxable year 1918 and the income tax imposed for such year will be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination will be credited or refunded to the taxpayer.[60] Such redetermination of value may be made (*a*) before the date of filing a return for that year, in which case the claim should be filed with the return, or (*b*) if no such claim is filed with the return, a claim may be filed subsequently thereto with the collector. Each claim should state the name and address of the taxpayer and should contain a concise statement of the amount of the loss sustained and the basis upon which it has been computed, together with all pertinent facts necessary to enable the Commissioner to determine the allowability of the claim. Each claim should be supported by an affidavit, and after one claim has been allowed no further claim can be considered. To be allowed such inventory loss must be substantial in amount and represent either (*a*) a realization by sale of goods taken in the inventory or (*b*) a shrinkage in market price (and such shrinkage must show sound evidence of permanency) of goods taken in the inventory and unsold at the date of the claim. In determining whether a loss has been realized by the sale of goods taken in the inventory, all sales made subsequent to the date of the inventory will be deemed to have been made from the inventoried stock until such inventoried stock is exhausted. No claim will be allowed for any loss of anticipated profits. Claims may also be made for a deduction from income of the taxable year 1918 of the amounts of payments actually made after the close of such taxable year on account of rebates in pursuance of contracts entered into during such year upon sales made

[60] Revenue Act of 1918, §§ 214 (a) 12 and 234 (a) 14.

during such year. In any case where payment of the tax has not been made prior to the filing of the claim no such payment shall be required upon the income covered by such claim until the claim is decided, but in such case the taxpayer shall accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the Commissioner, conditioned for the payment of any part of such tax found to be due. If any part of such claim is disallowed, then the remainder of the tax due shall bear interest at the rate of one per cent per month from the time the tax would have been due had no such claim been filed. The amount allowed by the Commissioner in respect of any such claim shall be deducted from the net income for the taxable year 1918, and the taxes shall be recomputed accordingly and the excess of tax due, if any, shall be credited or refunded to the taxpayer. In computing income for the taxable year 1919, the opening inventory must be properly adjusted by the taxpayer in respect of any claim allowed for the year 1918 under this provision. Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be the goods most recently purchased.[61]

Net Losses. When used in this paragraph the term "net loss" refers only to net losses resulting from either (1) the operation of any business regularly carried on by the taxpayer, or (2) the *bona fide* sale by the taxpayer of plant, buildings, machinery, equipment or other facilities, constructed, installed or acquired by the taxpayer on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war; and when so resulting means the excess of the deductions allowed by law (excluding in the case of corporations amounts received as dividends from a corporation taxable upon its net income, and amounts received as dividends from a personal-service corporation out of earnings or profits upon which income

61 Reg. 45, Art. 261.

tax has been imposed) over the sum of the gross income plus any interest received free from income or excess-profits taxes. If for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount of such net loss will, under regulations prescribed by the Commissioner with the approval of the Secretary be deducted from the net income of the taxpayer for the preceding taxable year; and the income and excess-profits taxes for such preceding taxable year will be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination will be credited or refunded to the taxpayer. If such net loss is in excess of the net income for such preceding taxable year, the amount of such excess will under regulations prescribed by the Commissioner with the approval of the Sécretary be allowed as a deduction in computing the net income for the succeeding taxable year. It is further provided that the benefit of the above provisions may be allowed to the members of a partnership and the beneficiaries of an estate or trust under regulations prescribed by the Commissioner with the approval of the Secretary.[62]

CLAIM FOR ALLOWANCE OF NET LOSS. A taxpayer having such a net loss may file a claim with the collector of the district in which the taxpayer's return for the preceding year was filed. Such claim should state the name and address of the taxpayer and should contain a concise statement of the amount of the loss sustained and the basis upon which it has been computed, together with all pertinent facts necessary to enable the Commissioner to determine the allowability of the claim. Each claim should be supported by an affidavit.[63]

[62] Revenue Act of 1918, § 204.
[63] Reg. 45, Art. 1602.

CHAPTER 31

DEDUCTION OF ALLOWANCE FOR DEPRECIATION, OBSOLESCENCE AND AMORTIZATION

In the case of individuals the Revenue Act of 1918 permits a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business of the individual, including a reasonable allowance for obsolescence.[1] Property not used in his business is excluded. In the case of non-resident aliens, the deduction for depreciation or obsolescence is permitted if and to the extent that it is connected with income arising from a source within the United States; and the proper apportionment and allocation of the deduction with respect to sources of income within and without the United States is determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.[2] In the case of corporations, the allowance is also for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence,[3] limited in the case of a foreign corporation as above indicated in the case of non-resident aliens.[4] The purpose of allowing a deduction each year for depreciation is to take care of the certain loss of property which takes place from year to year, due to wear and tear. The property must be used or employed in the trade or business of the taxpayer. No depreciation is allowed, for instance, on a dwelling house occupied by the owner

1 Revenue Act of 1918, § 214 (a) 8.
2 Revenue Act of 1918, § 214 (b).
3 Revenue Act of 1918, § 234 (a) 7.
4 Revenue Act of 1918, § 234 (b).

as a private residence.[5] The new provisions of the Revenue Act of 1918 for the deduction of a reasonable allowance for obsolescence and amortization are treated in this chapter in addition to the subject of depreciation of property used in the trade or business of a taxpayer.

Depreciation Under Preceding Income Tax Laws. The 1909 Law allowed the deduction of "all losses including a reasonable allowance for depreciation of property, if any." The 1913 Law allowed as a deduction in the case of individuals "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business," and in the case of corporations "all losses including a reasonable allowance for depreciation by use, wear and tear of property, if any." The 1916 Law allowed to individuals a deduction of "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade," and to corporations a deduction of "all losses including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade."

Tangible Property Subject to Wear and Tear. Depreciation as an allowable deduction in ascertaining net income for the purpose of the income tax is not to be confused with the deduction for loss. The depreciation permitted to be taken as a deduction is the value assigned to the deterioration of physical improvements or assets such as are susceptible of having their value lessened through wear and tear.[6] Assets of any character which are not affected by use, wear and tear (except patents, copyrights, etc.) are not subject to the depreciation authorized by the law.[7]

LOSS IN RENTAL VALUE OF BUILDINGS. In the case of buildings the deduction on account of depreciation shall not include any allowance for an estimated loss due to

[5] T. D. 2153.
[6] Reg. 33 Rev., Art. 159; T. D. 2005.
[7] Reg. 33 Rev., Art. 162; T. D. 2152; T. D. 2137.

lessening of rental value, nor shall the computation of the deduction be influenced by the changed environment after a period of years, nor by its lack of adaptability to the use originally intended nor to any other outside influence affecting its value but allowable depreciation shall be determined solely upon the estimated life of such buildings after making the due allowance for ordinary repairs, the cost of which may be deducted as expenses for maintenance and operation.[8]

Real Estate. Real estate, as such, and as distinct from the improvements thereon, is not reduced in value by reason of wear and tear and an allowance for depreciation in the case of real-estate does not apply to the grounds, but is intended to measure the decline in the value of the improvements due to wear and tear of such improvements.[9] In determining the cost of the real estate upon which depreciable property is located, it frequently occurs that no segregation is made of the cost of the buildings as separate and distinct from the cost of the ground upon which such buildings stand. In such cases where the actual cost of the buildings or improvements at the time they were taken over by the corporation can not be definitely determined, it will be sufficient for the purpose of determining the rate of depreciation to be used in computing the amount which will be deductible from gross income to estimate the actual value at the time acquired, of buildings or improvements if acquired after March 1, 1913, or the fair market price or value as of that date if the property was acquired prior to March 1, 1913.[10]

Farm Buildings and Machinery. Depreciation may be claimed on farm buildings and farm machinery (but not on the dwelling occupied by the owner) and also on other physical farm property subject to wear and tear.[11]

Stock for Breeding Purposes. A farmer may claim de-

[8] Cohen v. Lowe, 234 Fed. 474; Reg. 33 Rev., Art. 162.
[9] Reg. 33 Rev. Art. 162; T. D. 2152; T. D. 2137.
[10] Reg. 33 Rev., Art. 163; T. D. 2137, T. D. 2152.
[11] T. D. 2153; T. D. 2665; Reg. 45, Art. 172.

preciation on live stock purchased for breeding, draft, or dairy purposes or any purpose other than resale, but should not claim depreciation on stock raised or purchased for resale.[12] Depreciation in the case of farmers ascertaining gross income by the inventory method is discussed fully in another chapter.[13]

WEARING APPAREL. If costumes purchased by actors and actresses are used exclusively in the production of a play and are not adapted for occasional personal use, and are not so used, deduction may be claimed on account of such depreciation in their value as occurs during the year on account of wear and tear arising from their use in the production of the play, or a loss may be claimed if they become obsolete at the close of the production.[14]

MERCHANDISE. It has been held that depreciation computed on total invoice cost of merchandise in stock is not an allowable deduction, except that if any portion of the merchandise in stock is unsalable by reason of obsolescence or damage, a depreciation deduction not in excess of the decline in value during the taxable year will be allowed.[15] The latest rulings, however, state that depreciation does not apply to inventories or to stock in trade.[16]

Intangible Property. Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, and limited leases, licenses, and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. For example, there can be no such allowance in respect of good will, trade names, trade-marks, trade brands, secret formulae, or processes. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the

12 Reg. 33 Rev., Arts. 4 and 123; Reg. 45, Art. 172.
13 See T. D. 2665. See Chapter 19 on Income from Farming.
14 Reg. 33 Rev., Art. 8; T. D. 2090.
15 Reg. 33 Rev., Art. 169.
16 Reg. 45, Art. 162.

business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner.[17]

Depreciation Allowance for Patent. In computing a depreciation allowance in the case of a patent or copyright, the capital sum to be replaced is the cost (not already deducted as current expense) of the patent or copyright or its fair market value as of March 1, 1913, if acquired prior thereto. The allowance should be computed by an apportionment of the cost of the patent or copyright or of its fair market value as of March 1, 1913, over the life of the patent or copyright since its grant, or since its acquisition by the taxpayer, or since March 1, 1913, as the case may be. If the patent or copyright was acquired from the Government, its cost consists of the various Government fees, cost of drawings, experimental models, attorney's fees, etc., actually paid. A taxpayer may elect not to take a depreciation allowance for patents, but such election if made is final and will control the returns for all subsequent years.[18]

Depreciation of Drawings and Models. A taxpayer who has incurred expenses in his business for designs, drawings, patterns, models, or work of an experimental nature calculated to result in improvement of his facilities or his product, may at his option deduct such expenses from gross income for the taxable year in which they are incurred or treat such articles as a capital asset to the extent of the amount so expended. In the latter case, if the period of usefulness of any such asset may be estimated from experience with reasonable accuracy, it may be the subject of depreciation allowances spread over such estimated period of usefulness. The facts must be fully shown in the return or prior thereto to the satisfaction of

17 Id. 163.
18 Id. 168.

the Commissioner. Except for such depreciation allowances no deduction shall be made by the taxpayer against any sum so set up as an asset except on the sale or other disposition of such assets at a loss or on proof of a total loss thereof.[19]

Capital Sum Returnable Through Depreciation Allowances. The capital sum to be replaced by depreciation allowances is the cost of the property in respect of which the allowance is made, except that in the case of property acquired by the taxpayer prior to March 1, 1913, the capital sum to be replaced is the fair market value of the property as of that date.[20] In the absence of proof to the contrary, it will be assumed that such value as of March 1, 1913, is the cost of the property less depreciation up to that date.[21] To this sum should be added from time to time the cost of improvements, additions, betterments, replacements, and renewals,[22] the cost of which is not deducted as an expense in the taxpayer's return, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from the gradual exhaustion of its utility which is the basis of the depreciation allowance. In the case of the acquisition after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump price, as, for example, land and buildings, the capital sum to be replaced is limited to that part of the lump price which represents the value of the depreciable property at the time of such acquisition.[23]

19 Id. 169.

20 It was held in early rulings that depreciation could only be claimed on the basis of cost whether or not the property was acquired prior to March 1, 1913 (T. D. 2446), but a later ruling recognized the principle of claiming depreciation on the value as of March 1, 1913, if the property was acquired prior thereto (T. D. 2754, August 23, 1918).

21 T. D. 2754.

22 As to incidental repairs see below.

23 Reg. 45, Art. 165.

Method of Computing Depreciation Allowance. The capital sum to be replaced should be charged off over the useful life of the property either in equal annual installments or in accordance with any other recognized trade practice,[24] such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and should be described in the return.[25]

Annual Allowances Measured by Life of Property. The annual allowance may be determined by dividing the cost by the probable number of years constituting the life of the property, the result being the amount which may be deducted annually. The life of the property necessarily depends upon its character, the use to which it is put and the conditions under which it is used. These elements being taken into consideration taxpayers are expected, as a result of experience and observation, very closely to approximate the number of years constituting the life of the property.[26] If, after property has been used for a certain purpose, it is put to another use by which it deteriorates more rapidly the allowance for depreciation may be increased accordingly. In estimating the life of the property it is assumed that the owner will make such repairs and renewals as are necessary to prevent undue deterioration. In the case of a building, for instance, depreciation is to be based upon the life of the building in the sense of the number of years the building will remain in a condition to be useful for the purpose for which it was constructed and is used, not merely the number of years it will stand without being condemned and torn down. In determining the life of the building it is assumed that the owner will keep it in good repair.[27]

24 Claiming depreciation in accordance with any practice other than that of dividing the cost by the useful life of the property is first recognized in this ruling.

25 Reg. 45, Art. 166.

26 T. D. 2152.

27 Cohen v. Lowe, 234 Fed. 474.

INCIDENTAL REPAIRS TO PROPERTY ON WHICH DEPRECIATION IS CLAIMED. Depreciation is not to be confused with ordinary repairs. It is intended to cover the estimated lessening in value of the original property, if any, due to wear and tear, decay, or gradual decline from natural causes, inadequacy, obsolescence etc., which at some time in the future will require the abandonment or replacement of the property, in spite of ordinary current repairs.[28] Such ordinary incidental repairs as keep the property in an operating condition should not be charged to depreciation reserve, but the cost should be charged to expense. A building or a piece of machinery or other equipment, as a whole, may deteriorate in value and usefulness by reason of wear and tear regardless of the fact that certain minor component parts may be renewed, restored or replaced. The depreciation deduction contemplates the creation of a fund that will renew, restore or replace the original property, when it has become worn out or exhausted, regardless of the renewal and restoration of parts that may have been made in the meantime. Hence, in addition to the depreciation deduction, the expense of incidental repairs which do not add to the value of the property, but merely keep it in an operating condition, and arrest deterioration may be deducted as expense in the year in which the repairs are made.[29]

RENEWALS TO PROPERTY. It is possible in some instances that worn out parts of a machine or similar equipment may be renewed, one after another, until the original machine or equipment is swallowed up in the renewed parts and the machine or equipment is then in as good operating condition as it was originally. In such cases, if the cost of renewed parts is charged to operating expense, no deduction on account of depreciation should be claimed as to such machine or equipment. Thus, in the case of pipelines, by replacing one joint of pipe after an-

[28] San Francisco Co. v. Scott, 253 Fed. 854.

[29] Letter from Treasury Department dated September 19, 1916; I. T. S. 1918, ¶ 1467; Reg. 33 Rev., Art. 131.

other all may be replaced and, if the expense of replacements is deducted as an operating expense, no depreciation fund should be set up for the purpose of restoring the pipeline as a whole. On the other hand, if a reserve is set up to cover property that may be renewed or restored part by part until the whole is renewed, the cost of the renewed part should be charged to the depreciation reserve fund and not to expense.[30]

ADDITIONS AND BETTERMENTS. Amounts expended in additions and betterments or for furniture and fixtures which constitute an increase in capital investment and add to the value of the assets are not a proper deduction, but such expenditures when capitalized may be extinguished through annual depreciation deductions, which latter deductions will be computed upon the basis of the cost and probable life of the property.[31]

Rate of Depreciation. The annual allowance for depreciation, is required by law to be "reasonable." No fixed rates are prescribed. The rule which has been established contemplates that the taxpayer may determine his annual deduction by dividing the cost of the property or the fair market price or value as of March 1, 1913, if acquired prior thereto, by the probable number of years constituting its life, in the manner indicated above, the result being the amount which may be deducted annually.[32] If it develops that by reason of underestimating the life of the property or by overestimating the

30 Letter from Treasury Department dated September 19, 1916; I. T. S. 1918, ¶ 1467.

31 Reg. 33 Rev., Art. 132.

32 Reg. 33 Rev., Art. 162. T. D. 2152. A collector who told taxpayers in his district that the amount of depreciation on frame buildings was limited to 3%, and in case of brick buildings to 2%, was informed by the Commissioner that while these rates might not be far from a reasonable and fair measure of depreciation sustained on such buildings, the rates should not be considered as the "limit," as the probable number of years constituting the life of the building might make the rate more or less than the figures stated. Letter from Treasury Department dated May 22, 1916; I. T. S. 1918, ¶ 1496.

rate of deterioration an amount in excess of the yearly depreciation has been taken, the rate applicable to future years should at once be reduced and the balance of the cost of the property not provided for through a depreciation reserve should be spread over the estimated remaining life of the property.[33]

Depreciation of Apartment Houses. In the case of an apartment house it was held by the court that where the Government had allowed 3% of the cost as annual depreciation the burden was on the owner to show that the amount so allowed was too small, the court considering the rate to be reasonable in this case.[34]

Depreciation of Steamers. It has been conceded that in a case involving the depreciation of a steamer, 5% of the book value thereof was a reasonable deduction which would contemplate a life of 20 years.[35]

Factories Running Night Shifts. In a case where machinery and equipment are operated more than the usual number of working hours, a greater rate of depreciation may be applied in determining the actual loss sustained than would be sustained in the case of machinery which is operated only eight or nine hours as the normal time. No definite rulings have been made as to the amount by which depreciation can be increased on this account. Each case is considered in connection with all the facts and figures relative thereto.[36]

Annual Allowance Must Be Entered on Books. A reasonable allowance for depreciation must be determined upon a basis of the cost of the property or the fair market price or value as of March 1, 1913, if acquired prior thereto and the probable number of years constituting its life. The amount of allowable depreciation deduction, thus ascertained, should be credited to a depreciation re-

33 Reg. 33 Rev., Art. 165; Reg. 45, Art. 167.

34 Cohen v. Lowe, 234 Fed. 474.

35 San Francisco Co. v. Scott, 253 Fed. 854.

36 Letter from Treasury Department dated July 12, 1918; I. T. S. 1918, ¶ 3620.

serve account, against which account will be charged the cost of renewing or replacing the property with respect to which depreciation is claimed.[37] The particular manner in which the amount shall be charged off is not material, except that the amount measuring a reasonable allowance for depreciation must be either deducted directly from the book value of the assets or credited to a depreciation reserve account, and as such shall be reflected in the annual balance sheet.[38] A journal entry alone is not sufficient.[39] Neither the 1909 Law nor the 1913 Law required that in order to secure a deduction for depreciation the amount claimed should be written off. It was, nevertheless, held by the Treasury Department that a depreciation deduction, in order to be allowable, must be so entered upon the books of a corporation as to constitute a liability against its assets.[40] A corporation is not entitled to a deduction from the amount of its gross income of any amount for depreciation unless the amount is charged off on the books of the corporation before the

[37] Letter from Treasury Department dated September 19, 1916; I. T. S. 1918, ¶ 1467; Reg. 33, Art. 130.

[38] Reg. 33 Rev., Art. 159; letter from Treasury Department dated February 12, 1915; I. T. S. 1918, ¶ 1526; Reg. 45, Art. 170.

[39] Letter from Treasury Department dated May 18, 1916; I. T. S. 1918, ¶ 1591.

[40] Letter to Collectors dated August 27, 1914; I. T. S. 1918, ¶ 1483. In a later ruling it was held that, under these acts the writing off of a depreciation would not be insisted upon in the adjustment of returns filed for the years 1909 to 1915 inclusive. (T. D. 2481, dated April 10, 1917.) In the meantime the courts had held, under the 1909 Law, that the contention that no allowance for depreciation could be claimed unless it was entered on the books of the company, recorded from time to time, was without force (U. S. v. Nipissing Mines Co., 202 Fed. 803 reversed in part on jurisdictional grounds, 206 Fed 431) and that the fact that a deduction was incorrectly carried on the books in surplus account did not justify the Government in disallowing it. Forty-Fort Coal Co. v. Kirkehdall, 233 Fed. 704. The Supreme Court of the United States declined, in Strattons' Independence v. Howbert, (231 U. S. 399) to answer the question as to whether or not a book entry was necessary, since the question was not properly brought before the court in that case.

deduction is allowed. This is required in order to insure that the returns of the corporation are in accord with its books of account and that thereby error and fraud with respect to the facts are presented. The statute is not, however, to be considered as requiring that depreciation, depletion and other losses be charged off within the taxable year. It is sufficient that they are charged off before they are allowed as deductions. Consequently the corporation may at any time reopen its books and charge off depreciation which it actually sustained during the taxable year. If the books are reopened for this purpose corresponding corrections must be made in the other book entries and if for any reason the facts do not warrant such other changes it will be held that the depreciation cannot be charged off and therefore cannot be allowed as a deduction. For example, if by reason of a distribution of earnings there is nothing from which to credit a reserve for depreciation no allowance for depreciation can be credited to depreciation reserve account.[41]

Reserves for Depreciation. In early rulings it was held that depreciation set up on the books and deducted from gross income could not be used for any purpose other than making good the loss sustained by reason of the wear and tear or exhaustion of the property; and that if any portion of the depreciation set up was diverted to any purpose other than making good the loss sustained by reason of such depreciation the amount would be disallowed. It was also held that the investment of depreciation reserve funds in additions, betterments and improvements was not contemplated by the law.[42] The present ruling holds the allowance for depreciation is to be credited to an

[41] Letter from Treasury Department dated June 25, 1918; I. T. S. 1918, ¶ 3599. The 1916 Law did not expressly require individuals to enter on their books the annual allowance for depreciation but with respect to domestic corporations it expressly provided that all losses, including the allowance for depreciation, must be "charged off" within the year. Revenue Act of 1916, §§ 5 (a), 6 (a), 12 (a), 12 (b). As to foreign corporations the law was silent.

[42] Reg. 33, Arts. 132 and 133; T. D. 2137.

appropriate reserve account and be carried as a liability against the assets, to the end that when the total of these credits equals the capital investment account no further deductions will be allowed. There is no requirement of law that the funds represented by these reserve liabilities shall be held intact or remain idle against the day when they may be used in making good the depreciation of the property with respect to which the deduction is claimed, or in restoring the capital investment in the depleted assets. The depreciation reserve may be invested in assets of any kind.[43]

Closing Depreciation Account as to Any Item. If the use of the property in the business is permanently discontinued, although no sale or other disposition of the property has been made, a determination of any gain or loss may be made; but any deduction in respect of any loss thereon must be disclosed in the taxpayer's return for the year in which the determination is made and a full statement of the facts and the basis upon which the computation is calculated must be attached to the return. Upon a sale or other disposition of the property, the consideration received shall be compared with the amount of the estimated salvage value used in computing the gain or loss as above provided, and the amount of the difference shall be treated as a gain or loss, as the case may be, of the year in which the sale or other disposition was made.[44]

[43] T. D. 2481. It was stated in Revised Regulations No. 33 as follows: "Depreciation set upon the books and deducted from gross income can not be used for any purposes other than in making good the loss sustained by reason of the wear and tear of the property with respect to which it is claimed. If. however, an investment is made in extensions, additions, or betterments of the company's own property, representing a part or the whole of the credit balance of the depreciation reserve account, such investment will not be considered a misuse or diversion of the depreciation deduction otherwise allowable." (Reg. 33 Rev., Art. 164.) The language used in the text above seems, however, to be a sounder statement of the law.

[44] Reg. 45, Art. 171.

Deductions by Lessees. The cost of erecting permanent buildings, or of making permanent improvements on ground leased by a company, is held to be an additional rental and is, therefore, a proper deduction from gross income, provided such buildings and improvements, under the terms of the lease, revert to the owner of the ground at the expiration of the lease. In such case, however, the cost will be prorated according to the number of years constituting the term of the lease and the annual deduction will be an aliquot part of such cost. The cost of the buildings being a rental charge and deductible on the prorated basis, the lessee corporation will not be permitted to deduct from gross income any depreciation with respect to such buildings, but the cost of incidental repairs necessary to keep them in efficient condition for the purpose of their use, may be deducted as an expense of operation and maintenance.[45]

Obsolescence. The Revenue Act of 1918 provides that the deduction permitted to individuals or corporations for the exhaustion, wear and tear of property used in trade or business, may include "a reasonable allowance for *obsolescence.*" Obsolescence is that loss which occurs in respect of tangible property from the changes due to the normal progress of the art in which such property may be used, or to becoming inadequate to the growing needs of the business. A taxpayer who in computing depreciation allowances in returns for years prior to 1918 has not taken ordinary obsolescence into consideration may for the year 1918 and subsequent years revise the estimate of the useful life of any property so as to allow for such future obsolescence as may be expected from experience to result from the normal progress of the art. No modification of the method should be made on account of changes in the market value of the property from time to time, such as, on the one hand, loss in rental value of buildings due to deterioration of the neighborhood, or, on the other, appre-

[45] Reg. 33 Rev., Art. 140; T. D. 2137.

ciation due to increased demand. The conditions affecting such market values should be taken into consideration only so far as they affect the estimate of the useful life of the property.[46]

OBSOLESCENCE UNDER 1916 LAW. The position taken by the Treasury Department under the 1916 Law was that obsolescence was not contemplated by the provision of the law relating to depreciation, and that no other provision of the law permitted an annual allowance with respect thereto, since neither the time when property may become obsolete nor the loss when the stage of obsolescence is reached, can be determined in advance with any degree of certainty.[47] The deduction for depreciation was limited to the creation of a reserve fund, out of which the loss due to use, wear, and tear might be compensated. It was not considered possible to determine in advance when a piece of machinery, equipment or even a building would become obsolete and the Treasury Department held that since obsolescence could not be anticipated, an annual deduction would not be permitted to take care thereof.[48] Amounts representing losses on account of obsolescence of physical property were permitted to be included under the 1916 Law as a deduction under the heading of loss, provided such amount had been recorded in the books following the condemnation and withdrawal from use of the obsolete property. The amount of obsolescence which might be claimed as a deduction, was

[46] Revenue Act of 1918, §§ 214 (a) 8, 234 (a) 9; Reg. 45, Arts. 162, 167.

[47] In earlier rulings, the Treasury Department held that depreciation applied to intangible property, subject to wear and tear, exhaustion or obsolescence (Reg. 33, Art. 129; T. D. 2005; T. D. 2077; T. D. 2090). In San Francisco Co. v. Scott, 253 Fed. 854, a case arising under the 1909 Law, which permitted the deduction of "losses * * * including a reasonable allowance for depreciation, if any," the court held that depreciation, as used in that Law, was intended to cover the estimated lessening in value of the original property, if any, due to wear and tear, decay or gradual decline from natural causes, inadequacy, and "obsolescence."

[48] Letter from Treasury Department dated September 19, 1916; I. T. S. 1918, ¶ 1467.

ascertained by deducting from the cost of the property the sum of (a) the total amount that had been previously deducted on account of the depreciation of the property, and (b) its residuary value at the time of obsolescence, or (c) the amount received from the sale of the property. The obsolescence deduction could not include the accumulated depreciation applicable to prior years.[49] If no depreciation had been charged off against the property, in respect of which obsolescence was claimed, from the gross income of prior years, the amount allowable as a deduction for the year in which the property became obsolete was ascertained by deducting from the cost of the property the sum of (a) its residuary value and (b) an amount equal to the depreciation actually sustained during the prior period, which might have been deducted when computed at the rate applicable to the same or similar property. The amount of depreciation thus arrived at, as applicable to former years, might be made the basis of amended returns, and a claim for a refund of taxes overpaid, by reason of the fact that no depreciation deduction was claimed in such years, might be made.[50]

Amortization. The 1916 Law made no provision for amortization of plants or equipment acquired for Government contract work. That law allowed the taxpayer only ordinary depreciation due to wear and tear without considering the elements of amortization or obsolescence.[51] The Revenue Act of 1918, however, provides that, (a) in the case of buildings, machinery, equipment or other facilities constructed, erected, installed or acquired on or after April 6th, 1917, for the production of articles contributing to the prosecution of the war with Germany, and (b) in the case of vessels constructed or acquired on or after April 6th, 1917, for the transportation of articles or men contributing to the prosecution of the war with Germany,

[49] Reg. 33 Rev., Art. 178.
[50] Reg. 33 Rev., Arts. 162 and 179.
[51] Letter from the Treasury Department dated January 4, 1919; I. T. S. 1918, ¶ 3716.

there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer. This allowance may not again include any amount otherwise allowed under the Revenue Act of 1918 or previous laws as a deduction in computing net income. At any time within three years after the termination of the war with Germany, as fixed by proclamation of the President, the Commissioner of Internal Revenue may, and at the request of the taxpayer must, re-examine the return and if he then finds, as a result of the appraisal or from other evidence, that the deduction originally allowed for amortization was incorrect, the income tax and war-profits and excess-profits taxes for the year or years affected, will be re-determined, and the amount of tax due upon such re-determination, if any, must be paid upon notice and demand by the collector. The amount of tax overpaid, if any, will be credited or refunded to the taxpayer.[52] Claims for amortization must be unmistakably differentiated in the return from all other claims for wear, tear, obsolescence, and loss. No such claim will be allowed unless it is reflected in any accounts submitted by the taxpayer to stockholders and in any credit statements by the taxpayer to banks, and is given full effect on his financial books of account. If Government or other contracts taken by the taxpayer contained recognition of amortization as an element in the cost of production, copies of such contracts shall be filed with the taxpayer's return, together with a statement and description of any sums received on account of amortization and the basis upon which they were determined. In any case in which an allowance has been made for amortization of cost the taxpayer will not be allowed to restore to his invested capital for the purpose of the war-profits and excess-profits tax any portion of the amount covered by such allowance.[53]

Property the Cost of Which May Be Amortized. The taxpayer may make a reasonable deduction from gross in-

52 Revenue Act of 1918, §§ 214 (a) 9, 234 (a) 8.
53 Reg. 45, Art. 185.

come not in excess of a sum sufficient to extinguish the cost of buildings, machinery, equipment, or other facilities constructed, erected, installed, or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, and of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the present war. A deduction on account of amortization will be allowed only in the case of enterprises or projects falling within the class of activities contributing to the prosecution of the present war.[54]

COST WHICH MAY BE AMORTIZED. The total amount to be extinguished by amortization is the difference between the original cost to the taxpayer of the property and its value to the taxpayer at the close of the amortization period (a) for sale or (b) for use, immediate or prospective, as part of the plant or equipment of a going business, whichever value is the larger, less any amounts otherwise deducted or deductible for wear, tear, obsolescence, and loss. In the case of property the construction or installation of which was commenced before April 6, 1917, and completed subsequently to that date, amortization will be allowed with respect only to the cost incurred on or after April 6, 1917.[55]

AMORTIZATION PERIOD. The period over which the deduction allowed is to be spread, or during which it is to be amortized, is the estimated period between the date of acquisition or completion of the property and the date upon which either (a) the property will become useless or (b) the taxpayer will be able to earn by operation or use a normal return upon the unamortized cost, whichever date is the earlier.[56]

METHOD OF AMORTIZATION. The proportion of allowable deduction to be allocated to each taxable year of the amortization period will be, as nearly as may be determined, the same proportion which the net income or profit derived

[54] Reg. 45, Art. 181.
[55] Reg. 45, Art. 182.
[56] Reg. 45, Art. 183.

during such taxable year bears to the entire net income or profit derived during the amortization period from the operation or use of such property.[57]

REDETERMINATION OF AMORTIZATION ALLOWANCE. Redetermination of the deduction allowed on account of amortization may, or at the request of the taxpayer must, be made by the Commissioner at any time within three years after the termination of the present war, and if as a result of an appraisal or from other evidence it is found that the deduction originally allowed was incorrect, the amount of tax due for each taxable year during the amortization period will be adjusted by additional assessment or by refund.[58]

INFORMATION TO BE FURNISHED BY TAXPAYER. To obtain the benefit of this provision of the statute the taxpayer must establish to the satisfaction of the Commissioner that the entire deduction claimed and the proportion claimed for any particular year are reasonable. The taxpayer shall also submit a supplementary statement setting forth the following information: (a) a description of the property in reasonable detail; (b) the date or dates on which the property was acquired, and from whom, or, if constructed, erected, or installed by the taxpayer, the dates on which such construction, erection, or installation was begun and completed; (c) evidence establishing the intention of the taxpayer on and after April 6, 1917, or on and after the date of acquisition or the date of beginning construction, erection, or installation, to devote such property or vessels to the production of articles (or, in the case of vessels, the transportation of articles or men) contributing to the prosecution of the present war; (d) the cost of construction, erection, installation, or acquisition; (e) the value of the property after termination of the amortization period; (f) a segregation of property, which will have no value (except for salvage) following the amortization period and of prop-

57 Reg. 45, Art. 184.
58 Reg. 45, Art. 186.

erty which will have value after such period for use in a going concern or business; (g) all deductions from gross income otherwise taken or claimed with respect to such property; (h) the computation by which the total amount to be extinguished by amortization was determined; and (i) the computation by which the proportion of the amortization charge claimed as deduction in the taxable year for which return is being made was determined.[59]

[59] Reg. 45, Art. 187.

CHAPTER 32

ALLOWANCE FOR DEPLETION OF MINES, OIL AND GAS WELLS, OTHER NATURAL DEPOSITS, AND TIMBER

The 1918 Law contains a provision for deducting an allowance of a part of the income derived from the production of mines, oil wells, gas wells or any other natural deposit and timber.[1] The same allowance is permitted to individuals as to corporations and is permitted to non-resident aliens or foreign corporations with respect to property located in the United States. The 1916 Law provided for an allowance for depletion in the case of mines, oil and gas wells.[2] That law provided, in the case of oil and gas wells, a reasonable allowance for actual reduction in flow and production, and in the case of mines a reasonable allowance not to exceed the market value in the mine of the product thereof which had been mined and sold during the year for which the return and computation were made. The present law does not limit the depletion in the same way but permits a reasonable allowance according to the peculiar conditions of each case. Both the 1916 Law and the 1918 Law permit the allowance for depletion to be based upon the value of the property as of March 1, 1913, or the cost if the property has been acquired since that date. The 1916 Law made no reference to lessees and the Treasury Department ruled that a lessee could claim no depletion with respect to the value of the natural deposit on March 1, 1913. The present law provides that in the case of leases the deduction

1 Rev. Act of 1918, § 214 (a) and § 234 (a).
2 Rev. Act of 1916, § 5, § 6 and § 12.

shall be equitably apportioned between the lessor and lessee. With respect to depletion the Treasury Department has ruled under the 1918 Law as follows:[3]

Depletion of Mines, Oil and Gas Wells. A reasonable deduction from gross income for the depletion of natural deposits and for the depreciation of improvements is permitted, based (a) upon cost, if acquired after February 28, 1913, or (b) upon the fair market value as of March 1, 1913, if acquired prior thereto, or (c) upon the fair market value within 30 days after the date of discovery in the case of mines, oil and gas wells discovered by the taxpayer after February 28, 1913, where the fair market value is materially disproportionate to the cost. The essence of this provision is that the owner of such property, whether it be a leasehold[4] or freehold, shall secure through an aggregate of annual depletion and depreciation deductions a return of the amount of capital invested by him in the property, or in lieu thereof an amount equal to the fair market value as of March 1, 1913, of the properties owned prior to that date, or an amount equal to the fair market value within thirty days after the date of discovery of mines, oil or gas wells discovered by the taxpayer on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the market value of the property is materially disproportionate to the cost; plus in any case the subsequent cost of plant and equipment (less salvage value), and underground and overground development, which is not chargeable to current operating expense, but not including land values for purposes other than the extraction of minerals. Operating owners, lessors, and lessees are entitled to de-

[3] Reg. 45, Arts. 201 to 233, inclusive.

[4] Under the 1916 Law no allowance for depletion was permitted in the case of a lessee but the lessee was permitted to claim "depreciation" on the actual bonus or other cost incurred in acquiring and developing property.

duct an allowance for depletion, but a stockholder in a mining or oil or gas corporation is not.[5]

Capital Recoverable Through Depletion Allowance in the Case of Owner. In the case of an operating owner in fee or a lessor the capital remaining in any year recoverable through depletion allowances is the sum of (a) the cost of the property, or its fair market value as of March 1, 1913, or its fair market value within 30 days after discovery, as the case may be, plus (b) the cost of subsequent improvements and development not charged to current operating expenses, but minus (c) deductions for depletion which have or should have been taken[6] to date, and (d) the portion of the capital account, if any, as to which depreciation has been and is being deducted instead of depletion.[7] The value of the surface of the land should be taken into consideration.[8] In no case, however, may a lessor take deductions for depletion in any year during the continuance of the lease in excess of the royalties payable thereunder for such year, nor may he include in his capital recoverable through such an allowance any part of development costs not borne by the lessor.[9]

Capital Recoverable Through Depletion Allowance in the Case of Lessee. In the case of a lessee the capital remaining in any year recoverable through depletion allowances is the sum of (a) the cost of the leasehold, or its

[5] Reg. 45, Art. 201.

[6] It is to be noted that the ruling contemplates that depletion must be taken consistently from year to year and more depletion than is allocated to the production of one year cannot be taken by reason of the fact that less has been deducted in a past year than could have been properly allocated to such past year.

[7] Depreciation should be claimed on rigs, tools, machinery of all kinds, pipes, casing, and other equipment necessary to the operation of the wells or the field. Depletion applies only to the loss due to exhaustion of the natural resource.

[8] That is, in the case of an owner the value of the surface of the land should not be considered as a part of the value of the natural deposit.

[9] Reg. 45, Art. 202.

fair market value as of March 1, 1913, or its fair market value within 30 days after discovery, as the case may be, plus (b) the cost of subsequent improvements and development not charged to current operating expenses, but minus (c) deductions for depletion which have or should have been taken to date, and (d) the portion of the capital account, if any, as to which depreciation has been and is being deducted instead of depletion. Any annual or periodical rents or royalties supplementing the bonus or other amount paid for the lease may be charged to current operating expenses or to capital account, and in the latter event will form a part of the capital returnable through deductions for depletion.[10]

Apportionment of Deductions Between Lessor and Lessee. As the value of property comprehends the interests of both lessor and lessee, no computation, for the purpose of depletion allowances, of the value of these interests separately as of any date which combined exceeds the value of the property in fee simple will be permitted.[11] The same principle applies to holders of fractional interests. If the aggregate deduction claimed is deemed excessive, the Commissioner may request the owner or lessee to show that the valuation claimed does not exceed the fair market value of the property at a specified date determined in the manner explained in article 206.[12] The lessor and lessee shall, with the approval of the Commissioner, equitably apportion the allowance in the light of the peculiar conditions in each case and on the basis of their respective interests therein. To the return of every taxpayer claiming an allowance for depletion in respect

10 Id. Art. 203.

11 This ruling means that the value of the property as of March 1, 1913, or the value as of thirty days after date of discovery must be apportioned between the lessor and lessee, but if for instance the lessee has paid a bonus in addition to royalties the lessee's depletion should in no case be less than the amount of the bonus regardless of what the value may have been on any particular date.

12 See page 502.

of (a) property in which he owns a fractional interest only or (b) a leasehold or (c) property subject to a lease, there shall be attached a statement setting forth the name and address and the precise nature of the holdings of each person interested in the property.[13]

Determination of Cost of Deposits. In any case in which a depletion or depreciation deduction is computed on the basis of the cost or price at which any mine, mineral deposit, mineral rights, or leasehold was acquired, the owner or lessee will be required upon request of the Commissioner to show that the cost or price at which the property was bought was fixed for the purpose of a *bona fide* purchase and sale, by which the property passed to an owner, in fact as well as in form, different from the vendor.[14] No fictitious or inflated cost or price will be permitted to form the basis of any calculation of a depletion or depreciation deduction, and in determining whether or not the price or cost at which any purchase or sale was made represented the actual market value of the property sold, due weight will be given to the relationship or connection existing between the person selling the property and the buyer thereof. [15]

Determination of Fair Market Value of Deposits. Where the fair market value of the property at a specified date in lieu of the cost thereof is the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or in methods of mining or extraction. The value sought should be that established assuming a transfer between

[13] Reg. 45, Art. 204.

[14] That is, owners of a natural deposit will not be allowed to base depletion on a greater value by reason of incorporating or re-incorporating where the change of ownership is one of form and not substance.

[15] Reg. 45, Art. 205.

a willing seller and a willing buyer as of that particular date. No rule or method of determining the fair market value of mineral property is prescribed, but the Commissioner will lend due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purposes of the capital stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, disinterested appraisals by approved methods, and other factors.[16]

Revaluation of Deposits Not Allowed. The cost of the property or its fair market value at a specified date, as the case may be, plus subsequent charges to capital account not deductible as current expense, will be the basis for determining the depletion and depreciation deductions for each year during the continuance of the ownership under which the fair market value or cost was fixed, and during such ownership there can be no revaluation for the purpose of this deduction. This rule will not forbid the redistribution of the capital account over the estimated number of units remaining in the property in accordance with either of the next two articles.[17]

Determination of Quantity of Ore in Mine. Every taxpayer claiming a deduction for depletion will be required to estimate with respect to each separate property the total units (tons, pounds, ounces, or other units) of ores and minerals reasonably known or on good evidence believed to have existed in the ground on March 1, 1913, or on the date of acquisition of the property, or within 30 days after the date of discovery, as the case may be. In estimating the total units of ores and minerals for purposes of de-

[16] Id. Art. 206.
[17] Id. Art. 207.

pletion the property must be considered in the condition in which it was on March 1, 1913, or the date of acquisition, or within 30 days after the date of discovery, but if subsequently during the ownership of the taxpayer making the return additional recoverable mineral deposits have been discovered or developed which were not taken into account in estimating the number of units for purposes of depletion, or if it shall be discovered by working, development, or exploration that ground previously estimated to contain commercially recoverable mineral is barren or contains only commercially unworkable mineral, a new estimate of the recoverable units of ores or minerals shall be made and when made shall thereafter constitute a basis for depletion. In the selection of the unit of estimate the custom or practice applicable to the type of mineral deposit and the character of the operations thereon should be considered. The estimate of the recoverable units of ores or minerals for the purpose of depletion shall include (a) the ores and minerals "in sight," "blocked out," "developed," or "assured," in the usual or conventional meaning of these terms in respect to the type of deposit, and may also include (b) "prospective" or "probable" ores and minerals (in the same sense), i. e., ores and minerals that are believed to exist on the basis of good evidence, although not actually known to occur on the basis of existing development, but "probable" or "prospective" ores and minerals may be computed for purposes of depletion only as extensions of known deposits into undeveloped ground.[18]

Determination of Quantity of Oil in Ground. In the case of either an owner or lessee it will be required that an estimate, subject to the approval of the Commissioner, shall be made of the probable recoverable oil contained in the territory with respect to which the investment is made as of the time of purchase, or as of March 1, 1913, if acquired prior to that date, or within 30 days after

18 Id. Art. 208.

the date of discovery, as the case may be. The oil reserves must be estimated for all undeveloped proven land as well as producing land. If information subsequently obtained clearly shows the estimate to have been materially erroneous, it may be revised with the approval of the Commissioner.[19]

Computation of Allowance for Depletion of Mines and Oil Wells. When the cost or value as of March 1, 1913, or within 30 days after the date of discovery of the property shall have been determined, and the number of mineral units in the property as of the date of acquisition or valuation shall have been estimated, the division of the former amount by the latter figure will give the unit value for purposes of depletion, and the depletion allowance for the taxable year may be computed by multiplying such unit value by the number of units of mineral extracted during the year. If, however, proper additions are made to the capital account represented by the original cost or value of the property, or unforeseen extraordinary circumstances necessitate a revised estimate of the number of mineral units in the ground, a new unit value for purposes of depletion may be found by dividing the capital account at the end of the year, less deductions for depletion to the beginning of the taxable year which have or should have been taken, by the number of units in the ground at the beginning of the taxable year. This number, unless a revision of the original estimate has been necessary, will equal the number of units in the ground at the date of original acquisition or valuation less the number extracted prior to the taxable year. If, however, a recalculation is needed, the number of units at the beginning of the year will be the sum of the gross production of the year and the estimated mineral reserves in the property at the end of the year.[20]

Computation of Allowance for Depletion of Gas Wells. On account of the peculiar conditions surrounding the

19 Id. Art. 209.
20 Id. Art. 210.

production of natural gas it will be necessary to compute the depletion allowances for gas properties by methods suitable to the particular cases in question and acceptable to the Commissioner. Usually, the depletion of natural gas properties should be computed on the basis of decline in closed or rock pressure, taking into account the effects of water encroachment and any other modifying factors. The following methods may also be used. In many fields more or less additional evidence on depletion is to be had from such considerations as (a) details of production (performance record of well or property); (b) decline in open flow capacity; (c) comparison with life histories of similar wells or properties, particularly those now exhausted; and (d) size of reservoir and pressure of gas. In using the closed pressure decline method, the pressure at which wells are abandoned may be subtracted from the observed pressures in order to determine the correct percentages. The estimates for properties in certain fields are subject to some further correction for various reasons, among which are (a) irregular encroachment of water or oil which reduces the rate of decline in pressure; (b) even though there be no encroachment of oil or water, the size of the reservoir remaining fixed, the pressure decline does not follow in exact and precise proportion to the amount withdrawn; and (c) as a rule less gas is marketed for 50 pounds of decline in the early history of the well than during the decline of a similar amount in the later history or after the pressure has become low. The gas producer will be expected to compute the depletion as accurately as possible and submit with his return a description of the method by which the computation was made. The following formula, in which the units of gas are pounds per square inch of closed pressure, may be used and is recommended: the quotient of the capital account recoverable through depletion allowances to the end of the taxable year, divided by the sum of the pressures at the beginning of the year less the sum of the pressures at the time of expected abandonment (which quotient is the unit

cost), multiplied by the sum of the pressures at the beginning of the taxable year plus the sum of the pressures of new wells less the sum of the pressures at the end of the tax year, equals the depletion allowance.[21]

Procedure for Computation of Depletion of Gas Wells in the Future. A closed pressure reading of a gas well which has been producing, or is near gas wells that have been producing, is reduced to a greater or less extent, depending on its location and the length of time it has been closed in. To get readings most useful for tax purposes it is necessary to record the length of time the well has been closed and to show how the pressure built up during this period. Several readings at successive times will tend to indicate the point at which the pressure becomes approximately stationary, that is, the point at which the closed pressure approaches as nearly as possible the maximum pressure which would be shown if the well and all others in the pool were closed for several months. The length of time required varies of course with the character of the sand, position of the packer, the location of the well with reference to other wells, the limits of the pool, and other considerations. The depth of the well, diameter of tubing, and line pressure when the well was shut off should be noted. Beginning with 1919, closed pressure readings of representative wells, if not of all wells, must be carefully made and kept. In order to standardize pressure readings, the well should remain closed until such time as the pressure will not build up more than 1 per cent of the total pressure in 10 minutes. Ordinarily 24 hours will suffice for this purpose, but some wells will need to remain closed for a longer period. If there is any water in the well it should be blown or pumped off before the well is closed. Since readings at the exact end of the fiscal year will ordinarily not be available, the pressure of that date may be obtained by interpolation or extrapolation, or in certain cases readings taken regularly in

21 Id. Art. 211.

September or some other month may be applicable to the end of the fiscal or tax year. As a general rule September closed pressure readings taken regularly furnish the best indication of depletion and it is recommended that such readings be made with especial regularity and care. Where interpolated readings are used the data from which they are obtained should be given. Gauges should be of appropriate capacity considering the pressure to be measured and should be frequently tested. Record should be kept of the numbers of the gauges, dates the gauges were tested, names of men testing, and other significant details.[22]

Computation of Allowance Where Quantity of Oil or Gas Uncertain. If for any reason the quantity of oil or gas on the property can not be determined with any degree of certainty, thus precluding the use of the unit cost method of computing depletion, the depletion deduction may be computed in accordance with some other method or rule satisfactory to the Commissioner. In case any method other than the unit cost method is proposed to be used by the taxpayer in computing his depletion allowance, a full description of the method used must be submitted with the return, together with a summary of the figures or calculations pertaining to such computation.[23]

Computation of Depletion Allowance for Combined Holdings of Oil and Gas Wells. In the case of owners of property containing oil wells and gas wells the rulings are as follows:

OIL PROPERTIES. The recoverable oil belonging to the taxpayer shall be estimated separately on the smallest unit on which data are available, such as individual wells or tracts, and these added together into a grand total to be applied to the total capital account returnable through depletion. The capital account shall include the cost or value, as the case may be, of all oil or gas leases or rights

[22] Id. Art. 212.
[23] Id. Art. 213.

within the United States and its possessions, plus all incidental costs of development not charged as expense nor returnable through depreciation. The unit value of the total recoverable oil or gas is the quotient obtained by dividing the total capital account recoverable through depletion by the total estimated recoverable oil or gas. This unit multiplied by the total number of units of oil or gas produced by the taxpayer during the taxable year from all of the oil and gas properties will determine the amount which may be allowably deducted from the gross income of that year. This total depletion allowance divided by the total capital account returnable through depletion will give the percentage of depletion for the taxable year. This percentage must be applied to the capital account returnable through depletion of each separate leasehold and fee property included in the holdings of the taxpayer to find the proper amount deductible for depletion from the capital account of each tract at the end of the taxable year.[24]

GAS PROPERTIES. In the case of the gas properties of a taxpayer the depletion allowance for each pool may be computed by using the combined capital account returnable through depletion of all the tracts of gas land owned by the taxpayer in the pool and the average decline in rock pressures of all the taxpayer's wells in such pool as in the formula given in article 211.[25] The total allowance for depletion of the gas properties of the taxpayer will be the sum of the amounts computed for each pool.[26]

Depletion of Mine Based on Advance Royalties. Where the owner has leased a mining property for a term of years with a requirement in the lease that the lessee shall mine and pay for annually a specified number of tons or other agreed units of measurement of such mineral, or shall pay annually a specified sum of money which shall be applied in payment of the purchase price or agreed royalty per unit of such mineral whenever the same shall thereafter

[24] Id. Art. 214.
[25] See page 504.
[26] Reg. 45, Art. 214.

be mined and removed from the leased premises, the value in the ground to the lessor for purposes of depletion of the number of units so paid for in advance of mining will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the mining or removal in such year of any ore or mineral so paid for in advance and for which deduction has been once made. If for any reason any such mining lease shall be terminated before the ore or mineral therein which has been paid for in advance has been mined and removed, and the lessor repossesses the leased property, an amount equal to the aggregate deductions for depletion allowed in respect of ore or mineral not mined and removed by the lessee, but still in the ground, will be deemed income to the lessor and will be returned as such for the year in which the property is repossessed.[27]

Depletion Account on Books. Every taxpayer claiming and making a deduction for depletion and depreciation of mineral property shall keep accurate ledger accounts in which shall be charged the fair market value as of March 1, 1913, or within 30 days after the date of discovery, or the cost, as the case may be, (a) of the property, and (b) of the plant and equipment, together with such amounts expended for development of the property or additions to plant and equipment since that date as have not been allowed as expense in his returns. These accounts shall be credited with the amount of the depreciation and depletion deductions claimed and allowed each year, or the amount of the depreciation and depletion shall be credited to depletion and depreciation reserve accounts, to the end that when the sum of the credits for depletion and depreciation equals the value or cost of the property, plus the amount added thereto for development or additional plant and equipment, less salvage value of the physical proper-

[27] Id. Art. 215.

ty, no further deduction for depletion and depreciation with respect to the property will be allowed. If dividends are paid out of a depletion or depreciation reserve, the stockholders must be expressly notified that the dividend is a return of capital and not an ordinary dividend out of profits.[28]

Statement to Be Attached to Return Where Depletion of Mine Claimed. To the return of the taxpayer claiming a deduction for depletion or depreciation or both there should be attached a statement setting out: (a) whether the owner is a fee owner or lessee or both; (b) a description of the property owned in fee, if any, and a description of the leasehold property, if any, including the date of acquisition and the date of expiration of the lease; (c) the fair market value as of March 1, 1913, or within 30 days of the date of discovery, or the cost, as the case may be, of the property owned in fee and the leasehold property, together with a statement of the precise method by which the value or the cost of freehold and leasehold property was determined; (d) the estimated number of units of mineral or ore at the date of acquisition or of valuation in the property owned in fee and in the leasehold property separately, together with an explanation of the method used in estimating in each case the number of units of mineral or ore for purposes of depletion; (e) the amount of capital applicable to each unit; (f) the number of units removed and sold during the year for which the return was made; (g) the total amount deducted on account of depletion and on account of depreciation, stated separately, up to the taxable year during the ownership of the taxpayer; and (h) any other data which would be helpful

[28] Id. Art. 216. See page 391 for ruling on dividends paid out of depletion reserves. It should be kept in mind that any dividend paid out will be deemed to be from earnings (and therefore taxable) unless the corporation has no surplus representing earnings accumulated since February 28, 1913.

in determining the reasonableness of the depletion and depreciation deductions claimed in the return.[29]

Statement to Be Attached to Return Where Depletion of Oil or Gas Claimed. To each return made by a person owning or operating oil or gas properties, there should be attached a statement showing for each property the following information, which may be given in the form of a table, if desired, by taxpayers owning more than one property: (a) the fair market value of the property (exclusive of machinery, equipment, etc., and the value of the surface rights) as of March 1, 1913, if acquired prior to that date; or the fair market value of the property within 30 days after the date of discovery; or the actual cost of the property, if acquired subsequently to February 28, 1913, and not covered by the foregoing clause; (b) how the fair market value was ascertained, if the property came under the first or second head under (a); (c) the estimated quantity of oil or gas in the property at the time that the value or cost was determined; (d) the name and address of the person making the estimate and the manner in which this estimate was made, including a summary of the calculations; (e) the amount of capital applicable to each unit (this being found by dividing the value or cost, as the case may be, by the estimated number of units of oil or gas in the property at the time the value or cost was determined); (f) the quantity of oil or gas produced during the year for which the return is made (in the case of new properties it is desirable that this information be furnished by months); (g) the number of acres of producing and proven oil or gas land; (h) the number of wells producing at the beginning and end of the taxable year; (i) the date of completion of wells finished during the taxable year; (j) the date of abandonment of all wells abandoned during the taxable year; (k) a property map showing the location of the property and of the producing and abandoned wells, dry holes, and proven oil and gas land; (1) the

[29] Id. Art. 217.

average gravity of the oil produced on the tract; (m) the number of pay sands and average thickness of each pay sand or zone on the property; (n) the average depth to the top of each of the different pay sands; (o) any data regarding change in operating conditions, such as flooding, use of compressed air, vacuum, shooting, etc., which have a direct effect on the production of the property; (p) the monthly or annual production of individual wells and the initial daily production of new wells (this is highly desirable information and should be furnished wherever possible); (q) (for the first year in which the above information is filed for a property which was producing prior to the taxable year covered by the above statement the following information must be furnished) annual production of the tract or of the individual wells, if the latter information is available, from the beginning of its productivity to the beginning of the taxable year for which the return was filed; the average number of wells producing during each year; and the initial daily production of each well; and (r) any other data which will be helpful in determining the reasonableness of the depletion deduction. When a taxpayer has filed adequate maps with the Commissioner he may be relieved of filing further maps of the same properties, provided all additional information necessary for keeping the maps up to date is filed each year. This includes records of dry holes, as well as producing wells, together with logs, depth, and thickness of sands, location of new wells, etc. By "production" is meant gross production of all oil or gas recovered from the wells and tanked or utilized. In those leases where no account is kept of the oil or gas used for fuel, the gross production will necessarily be that remaining after the fuel used in the property has been taken out. In cases of this kind an estimate of the fuel used from each tract should be given for each year.[30]

Discovery of Mine. The discovery of a mine or a natural deposit of mineral, whether it be made by an owner

[30] Id. Art. 218.

of the land or by a lessee, shall be deemed to mean (a) the *bona fide* discovery of a commercially valuable deposit of ore or mineral of a value materially in excess of the cost of discovery in natural exposure or by drilling or other exploration conducted above or below ground, or (b) the development and proving of a mineral or ore deposit which has been abandoned or apparently worked out, or sold, leased, or otherwise disposed of, by an owner or lessee prior to the development of a body of ore or mineral of sufficient size, quality, and character to determine it, in connection with the physical and geological conditions of its occurrence, to be a mineable deposit of ore or mineral having a value materially in excess of the cost of the proving and development. In determining whether a discovery has been made the Commissioner will take into account the peculiar conditions of the case, and every taxpayer claiming the value of a mineral deposit on the date of discovery or within 30 days thereafter for purposes of depletion will be required to attach to his return a statement setting forth the conditions and circumstances of the discovery and the size, character, and location of the deposit, together with the cost of discovery, its value, and the precise method used in determining the value.[31]

Discovery of Oil and Gas Wells. In order to take advantage of his discovery on or after March 1, 1913, of oil or gas wells, the taxpayer must show (a) that the tract for which such valuation is claimed was not, as to the particular sand or zone discovery of which is claimed, proven oil land at the time the so-called discovery was made, proven oil land being that which has been shown by finished wells,

[31] Id. Art. 219. The term "discovery" has been defined in a number of cases relating to the location of mining claims, but the word "discovery" as used in this statute is not used in the sense employed in Revised Statutes, § 2320, under which section it has been held that a sufficient "discovery" to justify a location on public lands need not be a discovery that the ground contains mineral in sufficient quantities to pay. See Words and Phrases, Volume 3, p. 2094.

supplemented by geologic data, to be such that other wells drilled thereon are practically certain to be commercial producers; (b) that the discovery was a *bona fide* discovery of a commercial well of oil or gas or both of these substances on the property in question, a commercial well being one whose production is such as to offer a reasonable expectation of at least returning the capital invested in such well through the sale of the oil or gas or both derived therefrom during its economic life; and (c) that the fair market value of the property was materially in excess of the cost.[32]

Proof of Discovery of Oil and Gas Wells. In order to meet the requirements of the preceding article to the satisfaction of the Commissioner, the taxpayer will be required, among other things, to submit the following with his return: (a) a map of convenient scale, showing the location of the tract and discovery well in question and of the nearest producing well, and the development for a radius of at least three miles from the tract in question, both on the date of discovery and on the date when the fair market value was set; (b) a certified copy of the log of the discovery well, showing the location, the date drilling began, the date of completion and beginning of production, the formations penetrated, the oil, gas, and water

[32] Id. Art. 220. This ruling seems to be an incomplete construction of the law in several respects. The law does not contemplate that the discovery shall be on unproven oil land, but only that the tract or lease should not have been purchased as a proven tract or lease. An owner may have purchased unproven land which later may be proven according to the tests set forth in (a) of the ruling. Nevertheless the owner would clearly be entitled to claim depletion on an amount greater than the original cost. The discovery of an oil bearing sand or zone does not seem to be contemplated so much as the discovery of a productive well, since the depletion is with respect to "oil or gas wells, discovered by the taxpayer." It seems that the law intends by clear language to allow one who has purchased an unproven tract or lease to claim depletion with respect to each well thereafter drilled on the land so long as he remains owner or lessee, based upon the value of the well determined thirty days after the oil begins to flow into it. And this should hold true of every well

sands penetrated, the casing record, and any other information tending to show the condition of the well on the date the discovery was claimed; (c) the logs of enough other wells drilled prior to the date of completion of the discovery in the vicinity of the discovery well to convince the Commissioner that the sand or zone discovery of which is claimed was not known prior to the so-called discovery; (d) a sworn record of production clearly proving the commercial productivity of the discovery well; (e) a sworn copy of the records, showing the cost of the property; and (f) a full explanation of the method of determining the value on the date of discovery or within 30 days thereafter, supported by satisfactory evidence of the fairness of this value.[33]

Charges to Capital and to Expense in the Case of Mine. In the case of mining operations all expenditures for plant equipment, development, rent, and royalty prior to production, and thereafter all major items of plant and equipment, shall be charged to capital account for purposes of depletion and depreciation. After a mine has been developed and equipped to its normal and regular output capacity, however, the cost of additional minor items of equipment and plant, including mules, motors, mine cars, trackage, cables, trolley wire, fans, small tools, etc., necessary to maintain the normal output because of increased length of haul or depth of working consequent on the extraction of mineral, and the cost of replacements of these and similar minor items of worn-out and discarded plant and equipment, may be charged to current expense of operations.[34]

Charges to Capital and to Expense in the Case of Oil and Gas Wells. Such incidental expenses as are paid for

drilled on such land although the tract may be "proven" before the well is drilled. Any other rule would seem to present insuperable practical difficulties as well as being a doubtful construction of the law.

[33] Id. Art. 221.

[34] Id. Art. 222.

wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as an operating expense or charged to the capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property, it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as an operating expense or charged to capital accounts returnable through depletion and depreciation as in the case of productive wells. Casing-head-gas contracts have been construed to be tangible assets and their cost may be added to the capital account returnable through depletion, following the rate set by the oil wells from which the gas is derived, or, if the life of the contract is shorter than the reasonable expectation of the life of the wells furnishing the gas, the capital invested in the contract may be written off through yearly allowances equitably distributed over the life of the contract. All oil produced during the taxable year, whether sold or unsold, must be considered in the computation of the depletion allowance for the taxable year.[35]

Depreciation of Improvements in the Case of Mine. It shall be optional with the taxpayer, subject to the approval of the Commissioner, (a) whether the cost or value of the mining property, including ores and minerals, plant and equipment, and charges and additions to capital account not charged to expense and deducted as expense on the returns of the taxpayer, shall be recovered at a rate established by current exhaustion of mineral, or (b) whether the cost or value of the mineral and charges to capital account of expenditures other than for physical property shall be recovered by appropriate charges based on depletion and

[35] Id. Art. 223.

the cost or value of plant and equipment shall be recovered by reasonable charges for depreciation calculated by the usual rules for depreciation or according to the peculiar conditions of the taxpayer's case by a method satisfactory to the Commissioner. Nothing in these regulations shall be interpreted to mean that the value of a mining plant and equipment may be reduced by depreciation or depletion deductions to a sum below the value of the salvage when the property shall have become obsolete or shall have been abandoned for the purpose of mining, or that any part of the value of land for purposes other than mining may be recoverable through depletion or depreciation.[36]

Depreciation of Improvements in the Case of Oil and Gas Wells. Both owners and lessees operating oil or gas properties will, in addition to and apart from the deduction allowable for the depletion or return of capital as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223.[37] The amount deductible on this account shall be such an amount based upon its capitalized value or cost equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation may for such property be based upon the length of life of the deposit.[38]

[36] Id. Art. 224.
[37] See page 516.
[38] Reg. 45, Art. 225. See Chapter 31 for discussion of depreciation.

Depletion and Depreciation of Oil and Gas Wells in Years Before 1916. If upon examination it is found that in respect of the entire drilling cost of wells, including physical property and incidental expenses, between March 1, 1913, and December 31, 1915, a taxpayer has been allowed a reasonable deduction sufficient to provide for the elements of exhaustion, wear and tear, and depletion, it will not be necessary to reopen the returns for years prior to 1916 in order to show separately in these years the portions of such deduction representing depletion and depreciation, respectively. Such separation will be required to be made of the reserves for depreciation at January 1, 1916, and proper allocation between depreciation and depletion must be maintained after that date. In any case in which it is found that the deductions taken between March 1, 1913, and December 31, 1915, are not reasonable, amended returns may be required for these years.[39]

Depletion of Timber. A reasonable deduction from gross income for the depletion of timber and for the depreciation of improvements is permitted, based (a) upon cost if acquired after February 28, 1913, or (b) upon the fair market value as of March 1, 1913, if acquired prior thereto. The essence of this provision is that the owner of timber property, whether it be a leasehold or a freehold, shall secure through an aggregate of annual depletion and depreciation deductions a return of the amount of capital invested by him in the property, or in lieu thereof an amount equal to its fair market value as of March 1, 1913, plus in any case the subsequent cost of plant, equipment, and development which is not chargeable to current operating expenses, but not including cutover land values.[40]

[39] Id. Art. 226.

[40] Id. Art. 227. Prior to the 1918 Law the statute did not provide for depletion of timber lands but the department prescribed rulings under which a deduction could be taken from gross receipts or made through a charge in the cost of manufacturing the timber into lumber. These rulings were practically to the same effect as those herein stated.

Capital Recoverable Through Depletion Allowance in the Case of Timber. In general, the capital remaining in any year recoverable through depletion allowances may be determined as indicated in articles 202 and 203.[41] In the case of leases the apportionment of deductions between the lessor and lessee should be made as specified in article 204.[42] Where it becomes necessary to determine the cost or fair market value as of March 1, 1913, of the property, the rules laid down in articles 205 and 206[43] should be followed so far as possible.[44]

Computation of Allowance for Depletion of Timber. An allowance for the depletion of timber in any taxable year shall be based upon the number of feet of stumpage cut during the year and the unit cost of the stumpage at the date of acquisition or the unit market value on March 1, 1913, if acquired prior thereto. The unit market value as of March 1, 1913, shall be the unit price at which the standing timber in its then condition and in view of its then environment could have been sold for cash or its equivalent. The amount of the deduction for depletion in any taxable year shall be the product of the number of feet of stumpage cut during the year multiplied by such unit cost or market value of the stumpage.[45]

Revaluation of Stumpage. The fair market value of stumpage when determined as of March 1, 1913, for the purpose of depletion allowances in the case of timber acquired prior thereto, shall be the basis for determining the depletion deduction for each year during the continuance of the ownership under which the fair market value of the stumpage was fixed, and during such ownership there can be no redetermination of the fair market value of the stumpage for such purpose. However, the unit market value of stumpage adopted by the taxpayer may subse-

[41] See page 499.
[42] See page 500.
[43] See page 501.
[44] Reg. 45, Part I, Art. 228.
[45] Id. Art. 229.

quently be changed if from any cause such value, if continued as a basis of depletion, should upon evidence satisfactory to the Commissioner be found inadequate or excessive for the extinguishment of the fair market value of the timber as of March 1, 1913.[46]

Charges to Capital and to Expense in the Case of Timber. In the case of timber operations all expenditures for plant, equipment, development, rent and royalty prior to production, and thereafter all major items of plant and equipment, shall be charged to capital account for purposes of depreciation. After a timber operation and plant has been developed and equipped to its normal and regular output capacity, the cost of additional minor items of equipment and the cost of replacement of minor items of worn-out and discarded plant and equipment may be charged to current expenses of operations.[47]

Depreciation of Improvements in the Case of Timber. The cost or value as of March 1, 1913, as the case may be, of development not represented by physical property having an inventory value, and such cost or value of all physical property which has not been deducted and allowed as expense in the returns of the taxpayer, shall be recoverable through depreciation. It shall be optional with the taxpayer, subject to the approval of the Commissioner, (a) whether the cost or value, as the case may be, of the property subject to depreciation shall be recovered at a rate established by current exhaustion of stumpage, or (b) whether the cost or value shall be recovered by appropriate charges for depreciation calculated by the usual rules for depreciation or according to the peculiar conditions of the taxpayer's case by a method satisfactory to the Commissioner. In no case may charges for depreciation be based on a rate which will extinguish the cost or value of the property prior to the termination of its useful life. Nothing in these regulations shall be interpreted to mean

46 Id. Art. 230.
47 Id. Art. 231.

that the value of a timber plant and equipment, so far as it is represented by physical property having an inventory value, may be reduced by depreciation deductions to a sum below the value of the salvage when the plant and equipment shall have become obsolete or worn out or shall have been abandoned, or that any part of the value of cut-over land may be recoverable through depreciation.[48]

Statement to Be Attached to Return Where Depletion of Timber Claimed. To the return of the taxpayer claiming a deduction for depletion or depreciation or both there should be attached a statement setting out (a) whether the owner is an owner in fee or a lessee or both; (b) a description of the property owned in fee, if any, and a description of the leasehold property, if any, including the date of acquisition and the date of expiration of the lease; (c) the cost of the freehold and the leasehold property; (d) the number of feet of timber removed and sold during the year for which the return was made; (e) the total amount deducted on account of depletion and on account of depreciation, stated separately, up to the taxable year during the ownership of the taxpayer; and (f) any other data which would be helpful in determining the reasonableness of the depletion and depreciation deductions claimed in the return. The taxpayer shall keep accurate ledger accounts as outlined in article 216, and in general should comply with the requirements of the foregoing articles relating to the depletion of mines and oil and gas wells, so far as applicable.[49]

Rule Under the 1909 Law. The Act of August 5, 1909, did not provide for deductions from gross income on account of depletion of natural resources. The fact that revenues derived from operating mines resulted to some extent in exhaustion of the capital, established under that law no ground for deducting the value of the ore from the

[48] Id. Art. 232.
[49] Id. Art. 233.

gross income.[50] Lessors could claim no deduction from royalties with respect to depletion.[51] Lessees were allowed to claim a deduction of a proportionate amount of the cost of the lease but not of the value of the deposit at the incidence of the tax.[52] Although the Treasury Department prescribed rulings for determining depletion under the 1909 Law [53] such rulings were not authorized by the statute and a corporation which had claimed depletion thereunder could not claim that the Treasury Department is estopped by such regulations from assessing the tax without allowing the benefit of any depletion under that law.[54]

Rule Under the 1913 Law. The 1913 Law allowed the taxpayer to deduct from gross income of the taxable year on account of depletion of natural deposits an amount not to exceed 5% of the gross value of the output of the ore at the mine during the year.[55] The Act did not require that the charge for depletion of natural deposits must actually be set up on the books of the taxpayer in order to constitute an allowable deduction. It was first held that such an entry must be made in order to obtain the benefit of the allowance,[56] but it was later held that failure to write off depletion would not result in disallowing the deduction.[57] It is now held that "An operating owner will determine the amount which he is entitled to deduct in his return as depletion by adding to the amount paid for the deposit or to its fair market value as of March 1, 1913, if acquired prior thereto, such costs of development since that date, as have not been deducted as expenses on his returns, and by dividing the resultant sum by the

[50] Stratton's Independence Limited v. Howbert, 231 U. S. 339; 34 Sup. Ct. 136; 58 L. Ed. 285.

[51] Sargeant Land Company v. von Baumbach, 242 U. S. 503.

[52] Biwabik Mining Company v. U. S., 247 U. S. 116.

[53] T. D. 1675.

[54] Goldfield Consolidated Mines Company v. Scott, 247 U. S. 126.

[55] Act of October 3, 1913, ¶ B and ¶ G.

[56] Letter from Treasury Department dated May 18, 1916.

[57] T. D. 2481.

number of units in the mine estimated as of the time of its acquisition or as of March 1, 1913, if acquired prior thereto, thereby determining the per unit cost or value. The taxpayer is then entitled to deduct as depletion for the years 1913, 1914 and 1915 the product of the per unit cost or value multiplied by the number of units produced within the year, *provided such amount does not exceed 5 per cent of the gross value of the output for the year at the mine.*"[58] Under the act of 1913 and under the act of 1916 a lessor is permitted a depletion allowance which is computed like that of an operating owner, except that where a mine was leased before March 1, 1913, the allowance for depletion in favor of the lessor is based not on the fair market value of the ore or mineral in place as of March 1, 1913, but on the lessor's interest therein on that date.[59]

Rule as to Mine Under the 1916 Law. Under the 1916 Law an operating owner is entitled to a reasonable allowance for depletion, limited in the case of mines to the market value in the mine of the product thereof mined and sold during the year, not exceeding in the aggregate the capital originally invested, or in case of purchase made prior to March 1, 1913, the fair market value as of that date. In order that a taxpayer may have the benefit of the authorized deduction for depletion, the amount claimed must actually be charged off on his books before the allowance can be granted.[60] An operating owner will determine

[58] Extract from circular entitled "Schedule for Depletion—1909-1917," issued by the Treasury Department, Mines and Minerals Section, 1919.

[59] Id. But since the courts have held that a lessee acquires no interest in the mineral deposits in place, but only the privilege of entering upon the premises and mining and removing such deposits, it would seem that the lessor's interest in a deposit as of March 1, 1913, was not, for the purpose of claiming depletion under the 1913 and 1916 Laws, diminished by reason of a lease existing on that date.

[60] The amount need not however be written off in the taxable year. It is sufficient if the amount is charged off before being allowed as a deduction. Consequently at the time of an examination of a corpora-

the amount which he is entitled to deduct as depletion in his returns by adding to the amount paid for the ore or mineral or to its fair market value as of March 1, 1913, if acquired prior thereto, such costs of development since that date as have not been deducted as expenses on his returns, and by dividing the resultant sum by the number of units in the mine estimated as of the time of its acquisition or as of March 1, 1913, if acquired prior thereto, thereby determining the per unit cost or value. The taxpayer is then entitled to deduct as depletion for the year 1916 and subsequent years the product of the per unit cost or value multiplied by the number of units produced within the year. However, when the aggregate of such deductions shall equal the cost or fair market value as of March 1, 1913, plus the amount subsequently expended in developing the property which had not been deducted as an expense, the taxpayer shall be entitled to no further deductions.[61]

Rule as to Lessees Under Prior Laws. As mining leases are held not to convey the mineral deposits in place, but only the privilege of entering upon the premises and mining and removing such deposits, under none of the acts of 1909, 1913, or 1916 is a lessee entitled to deduction from income on account of depletion. But under the provisions of the acts of 1909, 1913, and 1916, authorizing the deduction from gross income of the ordinary and neces-

tion it is allowed to reopen its books and charge off depletion which it actually sustained for any taxable year during which the 1916 Law was in effect. If however the facts do not warrant the opening of the books and charging off depletion for any past year it will not be allowed as a deduction. Thus, for example, if all the earnings of a year have been distributed and there is nothing from which to credit a reserve for depletion no allowance for depletion can be credited to a reserve account or permitted as a deduction. (Letter from Treasury Department dated June 25, 1918; I. T. S. 1918, ¶ 3599.)

61 Extract from circular entitled "Schedule for Depletion—1909-1917," issued by the Treasury Department, Mines and Minerals Section, 1919.

sary expenses of the business, including rentals, the lessee may deduct royalties paid as such necessary expenses, and in the event that he paid a lump sum for his lease, such sum may be considered as rent paid in advance and, together with the cost of development not deducted as expenses on his returns, may be divided by the estimated number of units in the mine as of the date of acquisition in order to determine the expense per unit for the purpose of deduction. The lessee is then entitled to deduct as expense the product of the per unit expense multiplied by the number of units produced within the year. If the lessee is unable to determine the proper amount based upon investment in accordance with the method outlined above, he may deduct in his return the *pro rata* portion of the amount expended for the lease and for development based upon the life of the lease.[62]

[62] Id.

CHAPTER 33

CREDIT FOR TAXES

The 1918 Law is the first American income tax law to recognize and provide against the double taxation of income of an individual or corporation deriving income from sources in two countries. Heretofore a citizen of the United States doing business in Canada has been taxed upon the net income arising from that business by the Canadian Government and upon the same net income by the United States. Under the present law the taxpayer in such position will be allowed to deduct from the total tax found to be due on his entire net income the amount of tax paid to Canada on the income arising in that country. The privilege is extended to the following classes of taxpayers and to the extent indicated.

Citizens of the United States. In the case of citizens of the United States the credit for taxes is the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country upon income derived from sources therein, or to any possession of the United States.[1]

Resident Aliens. In the case of an alien resident of the United States who is a citizen or subject of a foreign country, the amount of income, war-profits and excess-profits taxes paid during the taxable year to such country, upon income derived from sources therein, may be credited against his tax payable to the United States if such country, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country.[2]

1 Revenue Act of 1918, § 222 (a) 1.
2 Id. § 222 (a) 3.

Non-Resident Aliens. No credit for taxes is allowed to a non-resident alien.[3]

Domestic Corporations. In the case of a domestic corporation (one created or organized in the United States) the credit for taxes is the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States.[4]

Foreign Corporations. No credit for taxes is allowed to a foreign corporation notwithstanding that it may have established its principal business in this country.[5]

Domestic Corporations Owning Stock of Foreign Corporations. A domestic corporation which owns a majority of the voting stock of a foreign corporation is entitled to credit for taxes in respect of any income, war-profits or excess-profits taxes paid (but not including taxes accrued) by such foreign corporation during the taxable year to any foreign country or to any possession of the United States upon income derived from sources without the United States in an amount equal to the proportion which the amount of any dividends (not deductible under Section 234 of the Law) [6] received by such domestic corporation from such foreign corporation during the taxable year bears to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid. But in no case may the amount of the credit for such taxes exceed the amount of the dividends on the stock of the foreign corporation received by the domestic corporation during the taxable year and not deductible under Section 234 of the Law.[7]

Members of Partnerships. If an individual is a member of a partnership he is entitled to his proportionate share of any income, war-profits and excess-profits taxes paid

[3] See Revenue Act of 1918, § 222.
[4] Revenue Act of 1918, § 238; Reg. 45, Art. 611.
[5] See Revenue Act of 1918, § 238.
[6] See p. 379.
[7] Revenue Act of 1918, § 240 (c); Reg. 45, Art. 636.

during the taxable year by the partnership to any foreign country or to any possession of the United States. The law does not appear to make any distinction between domestic or foreign partnerships, but it seems that if the member of a partnership is a resident alien he is entitled to the credit only "if such country, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country."[8]

Beneficiaries of Estates or Trusts. Beneficiaries of estates or trusts are entitled to their proportionate share of such taxes of the estate or trust paid during the taxable year to a foreign country or to any possession of the United States. It seems if the beneficiary is a resident alien he is limited in the same manner as though he received the income direct.[9]

Taxes Paid During the Taxable Year. "Amount of * * * taxes paid during the taxable year" means taxes proper (no credit being given for amounts representing interest or penalties) paid or accrued during the taxable year on behalf of the taxpayer claiming credit. "Foreign country" means any governmental authority, not that of the United States or any part or possession thereof, having power to impose such taxes, and it therefore includes a self-governing colony, such as the Dominion of Canada. "Any possession of the United States" includes, among others, Porto Rico, the Philippines, and the Virgin Islands.[10]

Conditions of Allowance of Credit. (a) When credit is sought for income, war-profits or excess-profits taxes paid other than to the United States, the income tax return of the taxpayer must be accompanied by a form,[11] carefully filled out with all the information there called for and with the calculations of credits there indicated, and duly signed and sworn to or affirmed. When credit is

8 Id. § 222 (b); Reg. 45, Art. 381.

9 Id.

10 Reg. 45, Art. 382.

11 Form 1116 for individuals or Form 1118 for corporations.

sought for taxes already paid the form must have attached to it the receipt for each such tax payment. When credit is sought for taxes accrued the form must have attached to it the return on which each such accrued tax was based. This receipt or return so attached must be either the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. In case only a sworn copy of a receipt or return is attached, there must be kept readily available for comparison on request the original, a duplicate original or a duly certified or authenticated copy. (b) In the case of a credit sought for a tax accrued but not paid, the Commissioner may require as a condition precedent to the allowance of credit a bond from the taxpayer in addition to the above form. If such a bond is required, the prescribed form [12] shall be used for it. It shall be in such penal sum as the Commissioner may prescribe, and shall be conditioned for the payment by the taxpayer of any amount of tax found due upon any redetermination of tax made necessary by such credit proving incorrect, with such further conditions as the Commissioner may require. This bond shall be executed by the taxpayer, his agent or representative, as principal, and by sureties satisfactory to and approved by the Commissioner.[13]

Redetermination of Tax When Credit Proves Incorrect. In case credit has been given for taxes accrued, or a proportionate share thereof, and the amount that is actually paid on account of such taxes, or a proportionate share thereof, is not the same as the amount of such credit, or in case any tax payment credited is refunded in whole or in part, the taxpayer shall immediately notify the Commissioner. The Commissioner will thereupon redetermine

[12] Form 1117 for individuals or Form 1119 for corporations.

[13] Reg. 45, Art. 383; see also Art. 611 as to corporations. Domestic corporations claiming credit for taxes with respect to taxes paid by a foreign subsidiary are permitted to avail themselves of subdivision (a) of this ruling, but not (b) as credit may be claimed only with respect to taxes paid (not those accrued) by foreign subsidiaries.

the amount of the income tax of such taxpayer for the year or years for which such incorrect credit was granted. The amount of tax, if any, due upon such redetermination shall be paid by the taxpayer upon notice and demand by the collector. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from such taxpayer under any other return, and any balance of such amount shall be immediately refunded to him.[14]

[14] Reg. 45, Art. 384.

CHAPTER 34

RETURN OF INCOME

For the purpose of assessing the tax, a return of income is required, showing specifically the items of gross income and the deductions and credits allowed by law. This chapter deals with the general provisions relating to returns of income, and does not cover the annual or special returns required with respect to withholding at the source, information at the source or other matters. For a discussion of such returns attention is directed to chapters on the respective subjects.

By Whom Filed. The law requires the return of income to be filed by every individual having a net income for the taxable year of $1,000 or over, if single or if married and not living with husband or wife, or of $2,000 or over if married and living with husband or wife.[1] A return is required of every fiduciary (with the exception of receivers appointed by authority of law in possession of part only of the property of an individual) for the individual, estate or trust for which he acts (1) if the net income of such individual is $1,000 or $2,000 as indicated above or (2) if the net income of such estate or trust is $1,000 or over or if any beneficiary of such estate or trust is a non-resident alien.[2] The term fiduciary is defined by the Revenue Act of 1918 to mean a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate.[3] Minors

[1] Revenue Act of 1918, § 223.
[2] Revenue Act of 1918, § 225.
[3] Revenue Act of 1918, § 200.

are now required to make their own returns but the return cf an incompetent must be filed by the committee of such incompetent. A return is required from every partnership, corporation and personal-service corporation subject to the tax regardless of whether or not it has been in receipt of any income during the taxable year.[4]

Accounting Period. The return of a taxpayer is made and his income computed for his "taxable year," which means his fiscal year, or the calendar year if he has not established a fiscal year.[5] The Revenue Act of 1918 defines the term "fiscal year" as meaning an accounting period of twelve months ending on the last day of any month other than December.[6] No fiscal year will, however, be recognized unless before its close it is definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith. The taxable year 1918 is the calendar year 1918, or any fiscal year ending during the calendar year 1918.[7] A taxpayer must make his return for the taxable year 1918 on the basis of his annual accounting period (fiscal or calendar year) even though a part of such accounting period was included in a period for which he had previously made return. Thus, an individual whose accounting period ended June 30, 1918, and who had previously made a return for the calendar year 1917, should make a complete return in accordance with the provisions of the law for the twelve months ending June 30, 1918. A taxpayer making his first return for income tax must make such return on the basis of his annual accounting period.[8] Except in the cases of a return for the taxable year 1918 and of a first return for income tax, a taxpayer must make his return on the basis (fiscal

[4] Revenue Act of 1918, §§ 224 and 239. The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which net income is computed.

[5] Reg. 45, Art. 25.

[6] Revenue Act of 1918, § 200.

[7] Revenue Act of 1918, § 200.

[8] Reg. 45, Art. 25. Revenue Act of 1918, § 226.

or calendar year) upon which he made his return for the taxable year immediately preceding unless, with the approval of the Commissioner, he has changed the basis of computing his net income.

CHANGE IN ACCOUNTING PERIOD. If a taxpayer changes his accounting period, he is required as soon as possible to give written notice to the collector for transmission to the Commissioner of such change and his reasons therefor. The Commissioner will not approve a change of the basis of computing net income unless such notice is given (a) at least thirty days before the due date of a taxpayer's return on the basis of his existing taxable year, and (b) at least thirty days before the due date of his return on the basis of the proposed taxable year. If the change in the basis of computing the net income of the taxpayer is approved by the Commissioner, the taxpayer must thereafter make his returns upon the basis of the new accounting period.[9]

Returns When Accounting Period Changed. No return can be made for a period of more than twelve months. A separate return for a fractional part of a year is, therefore, required wherever there is a change, with the approval of the Commissioner, in the basis of computing net income, or wherever a taxpayer makes his first return of income on the basis of a fiscal year.[10] If the change is from calendar year to fiscal year, a separate return must be made for the period between the close of the calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year, a separate return must be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year. If the taxpayer making his first return for income tax keeps his accounts on the basis of a fiscal year, he must make a separate return for the period between the beginning of the calendar

[9] Reg. 45, Art. 26. See Revenue Act of 1918, § 226.
[10] Revenue Act of 1918, § 226; Reg. 45, Art. 431.

year in which such fiscal year ends and the end of such fiscal year.[11] The requirements with respect to the filing of a separate return and the payment of tax for a part of a year, are the same as for the filing of a return and the payment of tax for a full taxable year closing at the same time.[12]

Individual Returns. The individual return is made on form 1040 (revised), except that it may be on short form 1040A (revised) where the net income does not exceed $5,000 and the net income subject to the normal tax, that is, after applying the personal exemption and other credits, does not exceed $4,000. The forms are provided by the Commissioner and may be had from the collectors of the several districts. In the case of a person owning State, municipal, or United States bonds, his return must contain a statement showing the number and amount of such obligations owned by him, the income received therefrom, and the other information called for in the form.[13]

HUSBAND AND WIFE. A husband and wife living together may make a single joint return. If a husband and wife, living together, have separate estates, the income from both may be reported in one return, but the amount of income of each, and the full name and address of both, must be shown in such return. Ordinarily, the husband, as the head and legal representative of the household, and general custodian of its income, should make and render the return of the aggregate income of himself and his wife. Unless the wife files a separate return of income or joins with her husband in a return which sets forth her income separately, her husband should include in his return the income accruing to the wife from services rendered by her or the sale of products of her labor.[14] If, however, the wife does not disclose her income to the husband, each may make a return, in which case the personal exemption may be divided be-

11 Revenue Act of 1918, § 226.
12 Revenue Act of 1918, §§ 226 and 239; Reg. 45, Art. 431.
13 Revenue Act of 1918, § 213 (b) 4; Reg. 45, Art. 401.
14 Reg. 45, Art. 401.

tween the two in such proportions as they agree upon. If either husband or wife separately has an income equal to or in excess of $2,000 a return is required under the law. If the aggregate income of both is $2,000 or more, the Treasury Department requires a return, although neither may have an income of $2,000.[15] Where husband and wife file separate returns of income, one of them being filed in time and the other delinquent, such returns are not supplemental of each other and delinquency must be answered for by the one in connection with whose return it occurred.[16]

MINORS. An individual under 21 years of age or under the statutory age of majority where he lives, whatever it may be, is required to render a return of income if he has a net income of his own of $1,000 or over for the taxable year. If the aggregate of the net income of a minor from any property which he possesses, and from any funds held in trust for him by a trustee or guardian, and from any earnings for his own use, is at least $1,000, a return as in the case of any other individual must be made by him, or by his guardian, or by some other person charged with the care of his person or property for him. If, however, a minor is dependent upon his parent, who appropriates or may appropriate his earnings, such earnings are income of the parent and not of the minor for the purpose of the normal tax and surtax. In the absence of proof to the contrary a parent will be assumed not to have emancipated his minor child and must include in his return any earnings of the minor.[17]

INCOMPETENTS. A fiduciary acting as the Committee of an insane person having an income of $1,000 or $2,000, according to the marital status of such person, must make a return for such incompetent on Form 1040 (revised) or 1040A (revised) and pay the tax. In such case, if the fiduciary is also acting for other beneficiaries, such a return

15 Reg. 45, Art. 401.
16 Reg. 33 Rev., Art. 26.
17 Reg. 45, Art. 402.

must be rendered in addition to the returns required by law for the trust estate.

AGENTS. The Revenue Act of 1918 provides that if a taxpayer is unable to make his own return, returns shall be made by a duly authorized agent, or by the guardian or other person charged with the care of a person or property of such taxpayer.[18] If the return is made by the agent, the reason therefor must be stated.[19] If the return is made by an agent, when by reason of illness, absence or nonresidence the person liable for return is unable to make it, the agent assumes the responsibility for making the return and incurs liability to the specific penalties provided for erroneous, false or fraudulent returns.[20] There may be a fiduciary relationship between an agent and the principal, but the word "agent" does not denote a "fiduciary" for purposes of the income tax.[21] Unless otherwise provided, therefore, the principal and not the agent is subject to the liability under the law.[22] Notice of failure to make return may be served upon an agent. Upon such notice the agent will be permitted to file evidence with the collector showing that the individual for whom he acts, did not receive an income subject to tax during the year, or that the agent filed the return with some other collector, as provided by Law.[23]

Partnership Returns. Under the 1916 Law, partnerships, as such, were not required to render returns of income, but under the present Law, they are required to do so.[24] Every partnership must make a return of income, regardless of the amount of its gross or net income. The return is made on Form 1065 (revised) and must be sworn to by one of the partners. Such return is required to be

18 Revenue Act of 1918, § 223.
19 See Form 1040.
20 Reg. 45, Art. 401.
21 Reg. 33 Rev., Art. 29.
22 T. D. 2137.
23 Reg. 33, Art. 18.
24 Revenue Act of 1918, § 224.

made for the taxable year of the partnership, that is, for its annual accounting period (fiscal year or calendar year, as the case may be) regardless of the taxable year of the partners.[25] If the partnership makes any change in its accounting period, it must make its return in accordance with the provisions of the Revenue Act of 1918, and the regulations of the Treasury Department, as indicated in a later paragraph of this chapter. A receiver in charge of the business of a partnership must make a return for it on form 1065 (revised).[26]

Corporation Returns. The subject of returns by corporations, including the new provisions regarding consolidated returns by affiliated corporations, is discussed in previous chapters.[27]

Where Returns Are Filed. The law permits the filing of a return by an individual in the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.[28] Although the law permits the return to be filed in either one of the two districts indicated above, the Treasury Department desires, for administrative purposes, that the return be filed in the district in which the individual resides.[29] Corporations are required to file their returns with the collector of the district in which is located the

25 See Revenue Act of 1918, §§ 200, 212, 218.

26 Reg. 45, Art. 411.

27 See Chapters 12 and 14 on Corporations and Foreign Corporations.

28 Revenue Act of 1918, § 227.

29 Letter from Treasury Department dated December 17, 1914; I. T. S. 1918, ¶ 596. The Treasury Department recognizes that the individual has the right to choose one of two districts where he resides in one and does business in another, and the filing in either district will be a proper compliance with the law. For the year 1913 the Treasury Department requested the filing of returns in the district in which the individual's principal place of business

principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States. then with the Collector at Baltimore, Maryland.[30]

When Filed. Returns of income must be made on or before the fifteenth day of Mareh following the taxable year, except that returns on the basis of a fiscal year other than the calendar year must be made on or before the fifteenth day of the third month following the close of the fiscal year.[31] The dates above indicated will be the primary due dates for all returns of income. Unless an extension of time is obtained, the taxpayer will be held delinquent if his return is not filed on or before the primary date and will be subject to the 25% additional tax and penalty of the law.[32] Returns on the basis of fiscal years ending in 1918 of taxpayers who made returns on the calendar year basis for the year 1917 must be made on or before the fifteenth day of March, 1919. Returns of individuals can not be accepted prior to the close of the taxable year, except that administrators or executors may immediately after their discharge upon final accounting file with the collector a return of income of the estate for the year in which the administration was closed, and should pay the tax found by such return to be due immediately upon receipt of notice and demand for the amount of such tax.[33]

LAST DUE DATE. These words are used to designate the last day upon which a return is required to be filed

was located. This threw an undue burden on the Collectors in large cities and the subsequent ruling was made in order to remedy this condition.

30 Revenue Act of 1918, § 241 (b). As stated in the chapter on Corporations, the principal office here referred to is the business office, not the statutory office in the State in which the corporation is incorporated. The return may be filed from the latter office only when a domestic corporation has no other office or place of business in this country.

31 Revenue Act of 1918, § 227 (a); Reg. 45, Art. 441.

32 T. D. 2001.

33 Reg. 45, Art. 441.

in accordance with the provisions of the law, or the last day of the period covered by an extension of time granted by the collector or Commissioner.[34] When the last due date as above defined falls on a Sunday or a legal holiday, the last due date will be held to be the day next following, and the return should be filed not later than such following day, or, if placed in the mails, it should be posted in ample time to reach the collector's office, under ordinary handling of the mails, on or before the date on which the return as here indicated is required to be filed in the office of the collector.[35]

MAILING RETURNS. If a return is mailed and placed in the United States mail, properly addressed and postage paid, in ample time and in due course of mail to reach the office of the Collector or Deputy Collector on or before the last due date, no penalty will be held to attach should the returns not actually be received by such officer until subsequent to that date.[36]

Extension of Time. The Revenue Act of 1918 makes provision in certain cases for an extension of time for filing returns. As indicated in the following paragraphs, such extensions may be granted either by collectors or by the Commissioner.

EXTENSION OF TIME BY COLLECTOR. It is important that the taxpayer render before the return due date a return as complete and final as it is possible for him to prepare. However, in cases of sickness or absence, collectors are authorized to grant an extension of not exceeding thirty days where, in their judgment, such further time is actually required for the making of the actual return.[37] The application for such extension must be made prior to the expiration of the period for which the extension is required. Otherwise the return will be considered de-

[34] Reg. 33 Rev., Art. 218.
[35] Reg. 33 Rev., Art. 219.
[36] Reg. 33 Rev., Art. 52.
[37] Revised Statutes, § 3176, as amended by the Revenue Act of 1918, § 1317. Reg. 45, Art. 442.

linquent, and liability to penalty will attach. Absence or sickness of one or more officers of a corporation at the time the return is required to be filed, will not be accepted as a reasonable cause for failure to file the return within the prescribed time, unless it is satisfactorily shown that there were no other principal officers available and sufficiently informed as to the affairs of the corporation to make and verify the return.

EXTENSION OF TIME BY COMMISSIONER. In addition to the limited extension of thirty days which may be granted by collectors, the Commissioner may grant a reasonable extension of time for filing returns whenever, in his judgment, good cause exists. He is required to keep a record of such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension may be for more than six months.[38] If, before the end of the thirty day extension granted by a collector, an accurate return cannot be made, an appeal for a further extension must be made to the Commissioner with a full recital of the causes for the delay, and the Commissioner will not grant an additional extension without a clear showing that a complete return cannot be made at the end of the thirty day period. The Commissioner will grant no extension beyond the original due date of the second installment of the tax. Either a complete or a tentative return as complete as possible and giving a ground for assessment of the tax, must be submitted on or before the due date as extended, and the tax shown to be due must be paid with the submission of the returns. If a complete return cannot be made at that time, the facts must be submitted to the Commissioner for such further action as he deems warranted. A tentative return will not be accepted as a basis for a partial or preliminary payment of tax on any due date if it be possible for the taxpayer to submit on or before that day a complete and final return.[39]

[38] Revenue Act of 1918, § 227 (a). Reg. 45, Art. 443.
[39] Reg. 45, Art. 442.

APPLICATION FOR EXTENSION OF TIME. A written application for an extension of time should be made by the taxpayer to the collector within the period for which the extension is desired. The application need not be made prior to the primary due date, but may be made at any time within the period for which the extension is desired, not to exceed thirty days after the primary due date when application is made to collectors. The application to the Commissioner for a further extension must be made before the expiration of the thirty day period which has been granted by the collector.[40]

EXTENSION OF TIME TO PERSONS ABROAD. In view of the disturbed conditions abroad and the consequent interference with the usual channels of communication, an extension of time for filing returns of income in 1918 and subsequent years has been granted by the Treasury Department in the case of non-resident alien individuals and corporations, or their proper representatives in the United States, and of American citizens residing or traveling abroad, including persons in the Military or Naval Service on duty outside the United States for such period as may be necessary, not exceeding ninety days after proclamation by the President of the end of the war with Germany. In all such cases, an affidavit must be attached to the return stating the causes of the delay in filing it, in order that the Commissioner may determine whether the failure to file the return on time was due to a reasonable cause and not to wilful neglect. If the showing justifies the conclusion that the failure to file the return in time was excusable, no penalty by way of addition to the tax will be imposed.[41]

EXTENSION OF TIME TO ENEMIES. The Treasury Department has granted an extension of time for such period as may be necessary, not exceeding ninety days after proclamation by the President of the end of the war with

[40] Reg. 45, Art. 442.
[41] Reg. 45, Art. 443.

Germany, for filing returns of income for 1918 and subsequent years by or for enemies or allies of enemies.[42] This extension, however, does not authorize any delay in filing returns of information. This extension is also subject to the condition that all persons who on October 6, 1917, have, or since have had, or may hereafter have control of any money or other property for any such enemy or ally of enemy, or who, on October 6, 1917, were, or since have been, or may hereafter be indebted to any such enemy or ally of enemy, shall hold and deliver all such money and property in all respects subject to the Trading with the Enemy Act, and to the orders of the President and the Alien Property Custodian thereunder, and shall in due course file returns of income in respect of all such money and property for such period as may elapse or have elapsed prior to the actual delivery of such money and property to the Alien Property Custodian.[43] In other words, if delivery was made in November, 1917, a return should be filed for the portion of the year 1917, elapsing before such delivery, and if delivery was in March, 1918, a return should be filed for the year 1917 and also before March 1, 1919, for such portion of the year 1918 as elapsed before such delivery.[44]

TENTATIVE RETURNS. Prior to the passage of the 1916 Law, extension of time could be granted only in case of sickness or absence, but the Treasury Department permitted foreign corporations and domestic corporations doing business in foreign countries who were unable to assemble their data on or before the primary due date, to file tentative returns, approximating as nearly as possible the actual business transacted during the year. Such tentative returns were accepted subject to the substitution later of true and correct returns when the necessary

[42] For who are "enemies" or "allies of enemies" see § 2 of the Trading with the Enemy Act of October 6, 1917.

[43] Reg. 45, Art. 444; T. D. 2673.

[44] Letter from Treasury Department dated May 3, 1918; I. T. S. 1918, ¶ 3351.

data to make the same had been received.[45] Under the 1916 Law the Commissioner had authority to grant unlimited extension in meritorious cases, thus making unnecessary the filing of tentative return.[46] Under the present Law, as previously indicated, the Commissioner will grant no extension beyond the original due date of the second installment of the tax. Either a complete, or a tentative return as complete as possible, and giving the ground for assessment of the tax must be submitted on or before the due date as extended, and the tax shown to be due must be paid with the submission of the return. If a complete return cannot be made at that time, the facts must be submitted to the Commissioner for such further action as he deems warranted. A tentative return will not be accepted as a basis for a partial or preliminary payment of tax on the due date if it be possible for the taxpayer to submit on or before that date a complete and final return. Returns made under the act must be made on the forms prescribed by the Treasury Department for each particular year and which are available at the offices of Collectors.[46a] In the absence of a prescribed form, a statement made by a corporation disclosing its gross income and deductions therefrom may be accepted as a tentative return, and if filed within the prescribed time a return so made will relieve the corporation from liability to the penalties imposed by law, provided that without unnecessary delay such a tentative return is replaced by a return made on the regular form.[47]

Forms. The forms on which the returns of income are to be made are prescribed by the Commissioner. The forms have been changed from time to time and those for 1918 will contain much new matter. As previously indicated, the forms for use by individuals are Form 1040 (revised) and Form 1040A (revised). The form pre-

[45] T. D. 2137.
[46] T. D. 2561 and T. D. 2581.
[46a] Reg. 33 Rev., Art. 210.
[47] Reg. 33 Rev., Art. 211; Reg. 45, Art. 626.

scribed for use by non-resident aliens is Form 1040 (revised), whether or not filed by the principal or by an agent on his behalf. Separate forms are provided for use by fiduciaries in cases where the tax is payable by the beneficiaries. In such case the form prescribed is Form 1041 (revised). A receiver in charge of the business of a partnership will render return on Form 1065 (revised). In other cases returns by fiduciaries are made on Form 1040 (revised) except that it may be on short Form 1040A (revised), where the net income does not exceed five thousand dollars. Partnerships make their returns on Form 1065 (revised). Corporations, whether domestic or foreign, make their returns on Form 1020.

Verification of Returns. All income tax returns must be verified under oath or affirmation. The affidavit may be made before the collector of the district or before any officer authorized by law to administer oaths.[48] Revenue agents, inspectors and special employees,[49] or any clerk in the office of the collector,[50] may, if commissioned as deputy collectors, take the oath of taxpayers. If a return is executed before a notary in a state where the law does not require the notary to use a seal, and none is used, a certificate of a clerk of court or other officer possessing a seal, showing that he is duly commissioned and authorized to administer oaths, should be filed with the Commissioner; otherwise the return will not be accepted,[51] unless, as may be done, the collector waives this requirement in states where jurats are accepted in the state courts either with or without a seal, and without certificate showing authority.[52]

VERIFICATION ABROAD. An individual residing abroad may acknowledge his return before any duly appointed officer of the country in which he resides, authorized to

48 Reg. 33, Art. 22.
49 T. D. 2235, T. D. 2238.
50 T. D. 2293.
51 T. D. 2090.
52 T. D. 2174.

administer oaths and use an official seal.[53] Where a foreign notary or other official having no seal acts as attesting officer, the authority of such attesting officer should be certified to by some judicial official or other proper officer having knowledge of the appointment and official character of the attesting officer. Income tax returns executed abroad may be attested free of charge before United States consular officers.[54]

VERIFICATION IN ARMY AND NAVY. Any officer in the Naval or Military service of the United States, within or without the United States, who is authorized to administer oaths for the purpose of Military justice and administration or Naval justice and administration, may take the acknowledgments of persons in the Naval and Military services.[55]

Assistance of Collectors. Any assistance or information which may be needed in connection with the preparing and filing of income tax returns, is required to be furnished by the collector upon request. Questions regarding the tax will be answered upon inquiry at the Internal Revenue offices. When questions are directed to the Treasury Department at Washington asking for information which should be supplied by collectors, the letters are referred to the collectors for reply and the writers are advised accordingly.[56]

Return Made by Collector. If the taxpayer fails to file a return as required by law, but consents to disclose the particulars of his income, it is the duty of the collector or deputy collector to make the return, which, being distinctly read and consented to, signed, and verified by the taxpayer, may be received as the return of the taxpayer.[57] The Revenue Act of 1918 provides that if any taxpayer

53 T. D. 2090.
54 Reg. 45, Art. 405.
55 T D. 2534.
56 T. D. 1949, T. D. 1956.
57 R. S. § 3173 as amended by § 1317 of the Revenue Act of 1918.

fails to make and file a return at the time prescribed by law, or makes, wilfully or otherwise, a false or fraudulent return, the collector or deputy collector must make the return from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, will be *prima facie* good and sufficient for all legal purposes.[58]

Erroneous Returns. If a return is improperly prepared, it is returned by the collector to the taxpayer for correction, and the corrected return is accepted without penalty, provided the incorrect return showing the date of its receipt accompanies the corrected return.[59] But an imperfect or incorrect return may not be accepted as meeting the requirements of the statute.[60]

Understatement in Returns. The Revenue Act of 1918 provides that if the collector or deputy collector has reason to believe that the amount of any income return is understated, he is required to give due notice to the taxpayer making the return to show cause why the amount of the return should not be increased and upon proof of the amount understated, he may increase the same accordingly. Such taxpayers may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector, may appeal to the Commissioner for his decision under such rules of procedure as may be prescribed by the Commissioner with the approval of the Secretary. If a collector suspects that the amount of any income is understated in a return, he may on his own initiative take up the

58 R. S. § 3176 as amended by § 1317 of Revenue Act of 1918.

59 Mimeograph letter to Collectors dated February 9, 1915; I. T. S. 1918, ¶ 609.

60 Reg. 45, Art. 626.

matter with the taxpayer and upon being satisfied that the amount was understated, may increase it accordingly, subject to the right of the taxpayer to appeal to the Commissioner. The Commissioner, however, without the intervention of the collector, may exercise original jurisdiction in cases of understatements or other errors in returns.[61]

Amended Returns. Where upon an audit of a return of an individual, a fiduciary, or a withholding agent, or as a result of an investigation made by a revenue agent, an additional tax is assessed, it is not necessary to file an amended return. Notice of the additional assessment will be given to the taxpayer by letter from the Treasury Department.[62] If a corporation discovers or detects expenses or liabilities which were due and payable during a preceding year, it is permissible for it to make an amended return for the year to which such expense or liability applies, include such expense in the deductions of that year, and file a claim for refund for any taxes overpaid by reason of the failure to deduct such expense or liability in the original return of that year.[63] Where a corporation is called upon by a revenue inspector to make amended returns, the officers of the corporation will be given the fullest opportunity to make any investigation they may desire prior to signing such amended returns, provided, of course, such investigation does not cover an unreasonable length of time.[64] In 1915 and 1916 it was the practice of the Treasury Department to send out a letter to corporations whenever items on the return were reached, concerning which more detailed information was sought, referring to the return and briefly requesting information regarding one or more items therein. The letter ended with a statement that in the absence of an explanatory affidavit, at the end of thirty days from the date of the letter, the entire amount of the

61 Reg. 45, Art. 451.

62 Mimeograph letter No. 1232 to Collectors; Reg. 33 Rev., Art. 38.

63 Reg. 33 Rev., Art. 128.

64 Letter from Treasury Department dated February 2, 1915; I. T. S. 1918, ¶ 1811.

deductions questioned would be suspended and an assessment returned accordingly.[65]

Notice of Failure to File Returns. Under the 1916 Law, when the collector possessed any information which led him to believe that any person in his district was in receipt of income for the year and did not make a return, he was required to serve a notice calling attention to the failure and to the fact that penalties for failure had been incurred. The notice also called attention to the fact that if the return was not filed within ten days from the date thereof, the books and papers of the taxpayer would be examined and a return prepared therefrom as provided by law.[66] The Revenue Act of 1918 provides that whenever in the judgment of the Commissioner necessary, he may require any person, by notice served upon him, to make a return or such statements as he deems sufficient to show whether or not such person is liable to tax.[67]

Inspection of Returns by the Public. The income tax law is specific and mandatory in the matter of safeguarding from publicity the information acquired by reason of its requirements relative to annual returns of income. The law imposes on employees of the Government a penalty of fine, imprisonment, dismissal from office and forfeiture of right to hold office, for making known in any manner not provided by the law, the amount or source of income, or any particulars thereof, set forth or disclosed in an income return by any person.[68] All internal revenue officers are cautioned to preserve as confidential all income tax re-

[65] I. T. S. 1917, ¶ 1623.

[66] Reg. 33, Art. 196. This notice was sent out on Form 1045. For the first year of the income tax, March 1 to December 31, 1913, the collector sent out an informal letter as a preliminary to the formal notice. This letter invited the taxpayer to make a return without penalty within ten days but the letter was not used in subsequent years.

[67] Revenue Act of 1918, § 1305.

[68] R. S. § 3167, as amended by the Revenue Act of 1918, Reg. 33 Rev., Art. 229.

turns.[69] The returns on which assessments have been made are filed in the office of the Commissioner of Internal Revenue and constitute public records and are open to inspection as such, but only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President.[70] It was held that a similar provision of the 1909 Law permitting the inspection of returns was not unconstitutional.[71] Pursuant to a similar provision of the 1913 Law, under date of July 28, 1914, the President issued an executive order, that returns should be subject to inspection in accordance with certain rules and regulations prescribed by the Secretary of the Treasury of the same date.[72]

RETURNS MUST BE INSPECTED AT WASHINGTON. Returns can be inspected by the public only in the office of the Commissioner of Internal Revenue in Washington. No collector or any other internal revenue officer outside of the Treasury Department in Washington is authorized to permit the inspection of any return, or to furnish any information whatsoever relative to any return, or any information secured by him in his official capacity relating to such return. No provision is made in the law for furnishing a copy of any return to any person or corporation and no copy will be furnished to any other than the person or corporation making the return, or their duly constituted attorney, except in the case where copies are furnished to officers of the Department of Justice for use in suits.[73]

RETURNS OF INDIVIDUALS. Returns of individuals are not open to the inspection of any person other than the proper officers and employees of the Treasury Department, the person who made the return or his duly authorized attorney, and are under no conditions made public, except where such publicity results through the use of such re-

69 T. D. 2135, T. D. 1962.
70 Revenue Act of 1918 § 257.
71 Flint v. Stone Tracy Co., 220 U. S. 107.
72 T. D. 2016. See Reg. 45, Art. 1091.
73 T. D. 2016. Reg. 45, Art. 1091.

turns in any legal proceeding in which the United States is a party.[74]

RETURNS OF FIDUCIARIES. An executor acts for his principal and not for the beneficiaries of the estate of his principal. Beneficiaries are not entitled, as such, to an inspection of returns of income filed by such executor.[75]

RETURNS OF CORPORATIONS. Under the 1916 Law the Secretary, at his discretion, upon application to him, setting forth what constituted a proper showing of cause, might permit the inspection of the return of any corporation by any bona fide stockholder thereof. Application for such inspection had to be made in writing to the Secretary, setting forth the reasons why inspection should be permitted. Attached to the application was required a certificate signed by the president or other principal accounting officer of such corporation, countersigned by the secretary, under the corporate seal of the company, that the applicant was a bona fide stockholder in the company. Where such certificate could not be secured, other evidence would be considered to determine the fact whether or not the applicant was a bona fide stockholder. Upon receipt of such application the corporation, whose return it was desired to inspect, was notified of the facts and given opportunity to state whether any legitimate reason existed for refusing permission. The privilege of inspecting the return of any corporation was personal to the stockholders, and the permission granted by the Secretary to make such inspection could not be delegated to any other person.[76] A person who, as trustee or in any other fiduciary relation, had the ownership or possessory right to stock in a corporation, was considered as a stockholder in such corporation.[77] By express exception in the Revenue Act of 1918 [78] a bona fide stockholder of record, owning one per cent. of the outstanding

[74] T. D. 2016. Reg. 45, Art. 1091.
[75] Reg. 33 Rev., Art. 26.
[76] T. D. 2016.
[77] Op. Atty. Gen. Dec. 27, 1910.
[78] Revenue Act of 1918, § 257.

stock of a corporation, is entitled as of right to examine the returns of income of such corporation and its subsidiaries. A stockholder desiring the privilege of inspection must apply in writing to the Commissioner, specifying his address, the name of the corporation, its outstanding capital stock, the number of shares owned by him, the date of their acquisition, and whether or not he has the beneficial as well as the record title to such shares, and in other respects complying with the requirements of the regulations issued under the law.[79] A stockholder who has acquired his shares for the purpose of inspection of the income returns of the corporation is not a bona fide stockholder.[80] A stockholder who examines the return of a corporation and reveals without express authority of law any particulars of its income statement is guilty of a misdemeanor and liable to fine and imprisonment.[81] Copies of returns on file in the Commissioner's office are not permitted to be sent to any person, except the corporation itself, or its duly authorized attorney, and in no case may the original returns be removed except under order and by direction of the Secretary or the President. A duly authorized attorney for this purpose is one possessing a properly executed power of attorney in writing by the corporation, which designation must be signed by two officers of the corporation and bear the impress of the seal.[82]

Corporations Which Offer Their Stock to the Public for Sale. The returns of all corporations, whose stock is advertised in the press or offered for sale to the public by the corporation itself, may be inspected by any person upon written application to the Secretary, which application shall set forth briefly and succinctly all facts necessary to enable the Secretary to act upon the request. In case of doubt as to whether any company falls within this classification, the person desiring to see such return should

79 Reg. 45, Art. 1093.
80 Reg. 45, Art. 1093.
81 Revenue Act of 1918, § 257.
82 Reg. 33 Rev., Art. 226.

support his application by advertisements, prospectus or such other evidence as he may deem proper to establish the fact that the stock of the corporation is offered for general public sale.[83]

CORPORATIONS WHOSE STOCK IS LISTED ON A STOCK EXCHANGE. The returns of all companies whose stock is listed upon any duly organized and recognized stock exchange within the United States, for the purpose of having its shares dealt in by the public generally, are open to the inspection of any person upon written application to the Secretary, which application shall set forth briefly and succinctly all facts necessary to enable the Secretary to act upon the request.[84]

Inspection of Returns by State Officers. By express exception in the Revenue Act of 1918[85] the proper officers of a State imposing an income tax are entitled as of right, upon the request of its governor, to have access to the returns of income of any corporation, or to an abstract thereof, showing its name and income. Upon written application by the governor of a State as prescribed by the regulations, except that the application may be made directly to the Commissioner instead of to the Secretary, the Commissioner will set a convenient time for inspection of the returns (or an abstract thereof as he may determine) of corporations organized or doing business in such State. The authority to inspect returns granted to officers of a State includes authority to inspect lists furnished to supplement and become a part of the returns.[86]

Inspection of Returns by Government Officers. Returns of corporations (but not of individuals) may be inspected

[83] Reg. 45, Art. 1091.

[84] Reg. 45, Art. 1091.

[85] Revenue Act of 1918, § 257. It is to be noted that the law permits inspection only by officers of states which impose an income tax. This may not necessarily mean a tax on both corporations and individuals, but the privilege to inspect returns applies only to the returns of corporations.

[86] Reg. 45, Art. 1092.

by an officer or employee of any department of the Government, on application to the Secretary by the head of the executive department in which such officer or employee is employed. If the return of a corporation is desired to be used in any legal proceedings other than those to which the United States is a party, or to be used in a manner by which any information contained in the return could be made public, the application for permission to inspect the return, or to furnish a certified copy, must be referred to the Attorney General for his recommendation before transmission to the Secretary.[87]

FOR USE IN GOVERNMENT SUITS. All returns whether of individuals or of corporations may be furnished, upon approval of the Secretary, for use in any legal proceedings before any United States grand jury, or in the trial of any cause to which both the United States and the person or corporation rendering the return are parties, provided the return would constitute material evidence in the prosecution, defense or trial of such action or proceeding. In any case arising in the collection of the income tax the Commissioner may furnish for the use of the proper officer either the original or certified copies of returns, without the approval of the Secretary.[88]

87 Reg. 45, Art. 1091.
88 Reg. 45, Art. 1091; Reg. 33 Rev., Art. 227.

CHAPTER 35

ASSESSMENT AND PAYMENT OF THE TAX

The Revenue Act of 1918 introduces a number of substantial changes from the former method of assessing the tax and the method formerly provided for paying the same. The 1916 Law expressly provided that all assessments should be made by the Commissioner.[1] The Revenue Act of 1918 seems to contemplate the same rule. As soon as practicable after returns are filed, they are sent to the Treasury Department at Washington for assessment of the tax.[2] When an assessment under the 1916 Law was made the amount thereof was reported to the local collector, who notified the taxpayer on or before June 1 of such amount.[3] Under the 1918 Law, the examination of a return by the Commissioner will lead to one of three results: (1) the return will be found to be correct; (2) the correct amount of tax will be *greater* than that shown in the return, or (3) the correct amount of tax will be *less* than that shown in the return. In the first case the tax is assessed on the basis of the taxpayer's return. In the second and third cases the four installments in which the tax is to be paid will be re-computed by the Commissioner. Under the 1916 Law, the tax became due on the 15th of June, but an additional period of grace, being at least ten days after June 15, was allowed before the application of penalties or interest.[4] As indicated above, the

1 Revenue Act of 1916, §§ 9 (a) and 14 (a).
2 Revenue Act of 1918, § 250.
3 Revenue Act of 1916, §§ 9 (a) and 14 (a).
4 See Revenue Act of 1916, §§ 9 (a) and 14 (a).

tax is now payable in four equal installments, the first at the time fixed by law for filing returns, the second, third and fourth installments on the 15th days of the third, sixth and nine months respectively after such date. Provision is made in all cases for payment in one installment, but no discount is allowed in such cases as was the case under the 1916 Law. If any installment is not paid when due, the whole amount of the tax unpaid becomes due and payable upon notice and demand by the collector; the difference between any installment as paid by the taxpayer and as re-computed by the Commissioner likewise becomes due and payable upon notice and demand by the collector. In the case of the first installment the instructions printed on the return are deemed sufficient under of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return is deemed sufficient notice of the amount due. Except in the cases of estates of insane, deceased or insolvent persons, if any tax remains unpaid after a tax is due and for ten days after notice and demand by the collector, the sum of 5% on the amount due but unpaid plus interest at the rate of 1% per month upon such amount from the time it became due is added as part of the tax, unless a *bona fide* claim for abatement has been filed. The net result is that the tax is now payable in the case of taxpayers reporting on the basis of the calendar year in four installments on or before March 25,[5] June 25, September 25 and December 26. In the case of taxpayers reporting on the basis of a fiscal year other than the calendar year, the same rules prevail, and the tax of such taxpayers will be payable on the 25th days of the third, sixth, ninth and twelfth months following the close of such fiscal year.[6] The Government may proceed by levying on and distraining the property of the taxpayer if

[5] If a taxpayer elects to pay all his tax at one time he has at least until March 25 in which to do so, i. e., ten days after date of notice and demand.

[6] Revenue Act of 1918, § 250.

payment of penalty and interest is not made within ten days from the date of the second notice and demand for the tax.[7] This drastic means of enforcing payment is within the legislative power of Congress since the power to tax includes the power to undertake effectual means to collect the tax. A new remedy in the case of taxpayers designing quickly to depart from the United States or to remove their property from the United States or to conceal themselves or their property therein or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax is provided by the Revenue Act of 1918, and in such cases the Commissioner may declare the taxable period for such taxpayers terminated at the end of the calendar month then last past and otherwise proceed as indicated in a later paragraph.[8]

Suit to Restrain Assessment or Collection. No suit for the purpose of restraining the assessment or collection of any tax may be maintained in any court.[9] The constitutionality of a law cannot be inquired into in an injunction suit against the government,[10] but may be in a stockholder's suit to enjoin the corporation from *voluntarily* paying a tax charged to be unconstitutional.[11] An injunction will not be granted at the instance of a stockholder to restrain the officers of a corporation from paying the tax, other than voluntarily, as that would, in effect, be the same as an action to restrain the Government.[12] Allegations that an assessment is irregular and void do not constitute any

7 See Page 561.

8 Revenue Act of 1918, § 250 (g).

9 R. S. § 3224.

10 Delaware R. R. Co. v. Prettyman, 17 Int. Rev. Rec. 99; Allen v. Pullman's Palace Car Co., 139 U. S. 658; Dodge v. Brady, 240 U. S. 122.

11 Pollock v. Farmers Loan & Trust Co., 157 U. S. 429; Flint v. Stone-Tracy Co., 220 U. S. 107; Brushaber v. Union Pacific R. R. Co., 240 U. S. 1; Stanton v. Baltic Mining Co., 240 U. S. 103.

12 Strauss v. Abrast Realty Co., 200 Fed. 327.

ground for an injunction.[13] A bill in equity will not lie to enjoin collection although the tax is alleged in the bill to have been illegally assessed.[14] A collector cannot be restrained from collecting an assessment by injunction.[15] It is contrary to every principle of equity jurisprudence that the collection of taxes on personal property should be stayed by injunction.[16] The courts will not interfere by a mandamus with the executive officers of the Government in the exercise of their ordinary official duties.[17] In matters which require an executive officer to exercise judgment or discretion no rule will issue for mandamus.[18] The inhibition of the Revised Statutes [19] applies to all assessments of taxes, made under color of their offices, by internal revenue officers charged with general jurisdiction of the subject of assessing the income tax. The remedy of a suit to recover back the tax after it is paid is provided by statute, and a suit to restrain its collection is forbidden. The remedy so given is exclusive, and no other remedy can be substituted for it. The system of administrative measures, not judicial, to collect internal revenue taxes, with appeals to specified tribunals, and suits to recover back moneys illegally exacted is a system of corrective justice intended to be complete, and enacted under the right belonging to the Government to prescribe the conditions on which it would subject itself to the judgment of the courts in the collection of its revenues.[20] In a recent case the question

13 Alkan v. Bean, 23 Int. Rev. Rec. 351.

14 Snyder v. Marks, 109 U. S. 189; Dodge v. Osborn, 240 U. S. 118.

15 State R. R. Tax cases, 92 U. S. 575; Keely v. Sanders, 99 U. S. 441.

16 Nye v. Washburn, 125 Fed. 818.

17 U. S. v. Black, 128 U. S. 40. The court in this case followed an earlier decision of Decatur v. Paulding (14 Pet. 497) and made clear the distinction between the mere ministerial act of the executive officer, which may be controlled by the courts by mandamus, and an act in the performance of which an officer is vested with quasi-judicial discretion.

18 Carrick v. Lamar, 116 U. S. 423.

19 R. S. § 3224.

20 Dodge v. Osborn, 240 U. S. 118.

arose whether or not a suit against a collector to cancel a sale to the government of the taxpayer's real estate to satisfy a tax assessed against him was prohibited and whether or not the word "restrain," as above used, should be construed in a narrow sense as prohibiting the issuance of restraining orders and injunctions or in a broad or liberal sense as applying to all suits to hinder or impede the collection of taxes. The court adopted the broader and more liberal definition.[20a]

Notice of Assessment. When the assessment under the 1916 Law had been made by the Commissioner of Internal Revenue the collector was notified and he sent the taxpayer a notice of assessment, usually on or before June 1.[21] This notice, however, was not a demand for payment of the tax, but was merely a notification of the amount which had been assessed and the date on which the tax was due and payable. Failure to pay the tax on receipt of this notice did not make the taxpayer liable for penalty or interest. In the case of a corporation making returns for a fiscal year, the notice of assessment was given on or before the expiration of ninety days from the day when the return was required to be filed.[22] This notice was sent because of the express provisions of the 1916 Law that "all persons (or corporations, joint-stock companies or associations, or insurance companies[23]) shall be notified of the amount for which they are respectively liable on or before

[20a] Gouge v. Hart, 250 Fed. 802. This case is now No. 506 on the docket of the United States Supreme Court.

[21] The notice was given to corporations on a form known as Form 1-647A and to individuals on Form 1-647B. The two forms were essentially the same. Each was divided into three parts, one part for the taxpayer (which operated as his receipt when he paid the tax), one part for the record of the Commissioner, and one part for the record of the local collector. When the tax was paid all three parts of the notice were presented to the local collector who properly receipted the part intended for the taxpayer and retained the other two parts.

[22] Reg. 33, Art. 177.

[23] Revenue Act of 1916, § 14 (a).

the first day of June." [24] The procedure under the 1918 Law is as follows. When the returns are received at the collectors' offices, they are examined and listed before being forwarded to the Commissioner. If it appears that the tax is greater or less than shown in the return, it is recomputed. After checking the figures the Commissioner assesses the tax on the basis of the collectors' lists. The collectors then send out bills for the taxes, either as computed by the taxpayer or as recomputed. If a taxpayer believes that he has been overassessed, he may file a claim for abatement or (after payment of the tax) for a refund of the excess. As soon as practicable the returns are carefully audited by accountants in the office of the Commissioner at Washington, assisted where necessary by reports of the examination of taxpayers' books and records made by revenue agents in the field. If error in a return is detected, the taxpayer is notified accordingly and an additional assessment is made against him or he is given the opportunity to file a claim for a refund, as the case may be. Any assessment must be made within five years after the return was due or was made, except in the case of false returns with intent to evade the tax.[25]

First Notice and Demand for Tax. If any installment of the tax is not paid on or before the date on which it is due, a notice and demand is issued to the taxpayer. Under the 1916 Law the corresponding notice and demand was usually dated and sent out on the day the tax was due. This notice and demand under the present law will call attention to the fact that the tax has been assessed, showing the amount due and may declare the whole of such amount remaining unpaid due and payable on or before a date given in the notice, which must be at least ten days in advance. Unless the tax is paid within the time specified the penalty imposed for delay in payment of the tax

[24] Revenue Act of 1916, § 9 (a).
[25] Reg. 45, Art. 1012.

will be added to the assessment.[26] This notice and demand is necessary in order to make the taxpayer liable for the penalty and interest in case of delay in payment of the tax, and is necessary to complete the government's lien on property belonging to the taxpayer,[27] and as a prerequisite to the distraint and sale thereof.[28] The fact that a claim for abatement is pending, or the tax is in litigation, does not relieve the collector from issuing the notice.[29] The notice may lawfully be given by mail and when so given is presumed to have been received. The burden rests on the taxpayer to prove the contrary in order to avoid the penalty.[30] The practice of the Department in such cases has been to permit the taxpayer to show, to the satisfaction of the Commissioner, that he did not receive the notice, and upon such showing to give the taxpayer an opportunity to pay his taxes without penalty. The record of the collector showing that notice had been duly mailed is considered merely as prima facie evidence that the notice was received.[31] The date appearing on the notice and demand, as the last date on which the tax may be paid without penalty, should be a date ten days subsequent to the actual mailing of the notice and not necessarily ten days from the date of the notice. The date of mailing controls.[32] In the case of the first installment the instructions printed on the return are deemed sufficient notice and demand of the date when the tax is due, and sufficient demand, and the tax-

[26] Revenue Act of 1918, § 250 (e); Reg. 33 Rev., Art. 231; Reg. 33, Art. 197. Under the 1916 Law Form 1-17A was used in notifying corporations and Form 1-17B in notifying individuals. The forms were essentially the same, each being divided in three parts in the manner and for the purpose described in the preceding note regarding the notice of assessment.

[27] R. S. § 3186, Revenue Act of 1918, § 1305.

[28] R. S. § 3187, Revenue Act of 1918, § 1305.

[29] T. D. 1995.

[30] U. S. v. General Inspection and Loading Co., 204 Fed. 657.

[31] I. T. S. 1917, ¶ 2268.

[32] T. D. 1659.

payer's computation of the tax on the return is deemed sufficient notice of the amount due.[33]

NOTICE AND DEMAND FOR DEFICIENCY. If on the examination of the return by the Commissioner of Internal Revenue, and recomputation by him of the amount of tax due, it appears that the correct amount of the tax is greater than that shown on the return, the difference is payable upon notice and demand by the collector.[34] A notice and demand is, therefore, necessary in such cases in order to advise the taxpayer of the amount of additional tax, as well as for the purposes indicated in the previous paragraph.

NOTICE AND DEMAND TO ABSENTEES. When an individual is absent in a foreign country and it is impossible for him to receive the notice and demand in time to make payment of the taxes assessed thereon within the ten-day period following the service of the notice, the collector will make an allowance so that the tax may be paid without penalty ten days after receipt of the notice, and, if the full amount of the tax has been placed in the mail for transmission within ten days after such receipt, the penalty and interest will not be exacted. This ruling applies also to corporations which by reason of the location of their offices cannot be reached by mail in sufficient time to enable payment to be made within ten days from the date of mailing of the notice and demand.[35]

Second Notice and Demand for Tax. If any tax is not paid within ten days after mailing the first notice and demand, a second notice and demand is given the taxpayer, which states that having failed to make payment of the tax within the prescribed time after notice and demand, there has attached a 5% penalty on the tax and interest at 1% per month from a specified date.[36] In this notice, de-

[33] Revenue Act of 1918, § 250 (3).

[34] Revenue Act of 1918, § 250 (b).

[35] T. D. 2028; Reg. 45, Art. 1007.

[36] Form 1-21A was used under the 1916 and former laws in giving corporations the second notice and demand for tax and Form 1-21B

mand is made for the taxes, penalty and such interest as may accrue before payment, together with a threat that if the tax, penalty and interest is not paid within ten days from the date of the notice, the Collector of Internal Revenue will collect the same with costs by seizure and sale of property.[37]

Time of Payment of Tax. Except as to any taxes paid at the source, the income tax is ordinarily paid in four equal installments.[38] The first installment is paid at the time fixed by law for filing the return, the second, third and fourth installments on the fifteenth days of the third, sixth and ninth months respectively following such date. There are now four primary due dates: to wit., March 15, June 15, September 15, and December 15 in the case of taxpayers reporting on the basis of a calendar year, and the 15th days of the third, sixth, ninth and twelfth months following the close of the fiscal year of taxpayers reporting

in notifying individuals. The forms are essentially the same, each being divided into three parts in the manner and for the purpose described in the note regarding the notice of assessment.

[37] Reg. 45, Art. 1009.

[38] Under the 1916 Law, the Secretary of the Treasury, under rules and regulations prescribed by him, was required to permit taxpayers to make payments in advance in installments of an amount not in excess of the estimated taxes which would be due from them, and upon determination of the taxes actually due any amount paid in excess was refunded as taxes erroneously collected. When payment was made in installments, the law required at least one-fourth of such estimated tax to be paid before the expiration of thirty days after the close of the taxable year, at least an additional one-fourth within two months after the close of the taxable year, at least an additional one-fourth within four months after the close of the taxable year, and the remainder of the tax due on or before the regular due dates fixed by law. The Secretary of the Treasury might allow a credit against taxes so paid in advance of an amount not exceeding the rate of 3% per annum, calculated upon the amounts so paid from the date of such payment to the regular due date; but no such credit was allowed on payments in excess of taxes determined to be due, nor on payments made after the expiration of four and one-half months after the close of the taxable year. (Act of October 3, 1917 (Public No. 50) § 1009; T. D. 2622.)

on the basis of a fiscal year other than the calendar year.[39] The payment of the tax may be made at any time on such due dates. If payment is made by mail the remittance should be mailed in due time to reach the collector on the due date. To accommodate those who make payments after closing time a mail box is provided at the cashier's window in the office of the local collector for the deposit of such collections.[40]

EXTENSION OF TIME FOR PAYMENT. Where an extension of time for filing a return is granted, the date of the expiration of the period of the extension is deemed the time fixed by law for filing the return and becomes the due date of the first installment. In case such extension is granted on request of the taxpayer, interest at the rate of ½ of 1 per centum per month is added to the installment from the date it would have been due if no extension had been granted, until the installment is paid.[41]

ADVANCE PAYMENT OF TAX. Income taxes may at the option of a taxpayer be paid in advance and in a single payment instead of installments, in which case the total amount must be paid on or before the time fixed by law for filing the return; to wit, March 15th or the fifteenth day of the third month following the close of a fiscal year other than the calendar year, as the case may be.[42] It appears in such cases if an extension of time for filing the return is granted the tax becomes due thereafter within ten days after date of notice and demand without addition of interest.

Medium of Payment of Taxes. As a general rule, payment of the tax is authorized by law [43] to be made in certified checks drawn in favor of the collector on national and state banks and trust companies located in the city where the collector has his office, and also such "out-of-town" certified checks as can be cashed without cost to

39 Revenue Act of 1918, § 250 (a).
40 T. D. 1728.
41 Revenue Act of 1918, § 250 (a).
42 Revenue Act of 1918, § 250 (a).
43 Act of March 2, 1911 (36 Stat. 965).

the government, providing the depositary will accept for deposit "out-of-town" certified checks "without recourse." Prior to 1917 the Treasury Department did not specifically authorize the acceptance of any form of exchange in payment of internal revenue taxes, other than currency and such certified checks as are above described.[44] There was no objection to a collector accepting at his own risk, or at the risk of the government depositary, uncertified checks or any other form of exchange, for collection only.[45] Where a form of remittance not authorized by law was accepted for collection, the 5% penalty was incurred by the taxpayer, if there was delay in collection and the funds were not actually received by the collector within the time provided by law. Receipt by the Government depositary, in the course of collection, was held not to be receipt by the collector, as the depositary is not an agent of the collector or of the government.[46] At present the law provides that collectors may receive at par with an adjustment for accrued interest, certificates of indebtedness issued by the United States in payment of income, war-profits and excess-profits taxes and any other taxes payable otherwise than by stamps.[47] Under the same provision of law collectors may also receive uncertified checks in payment of such

[44] T. D. 1990.

[45] T. D. 2158.

[46] T. D. 1651.

[47] Revenue Act of 1918, § 1314. It was formerly provided that under rules and regulations prescribed by the Secretary, collectors might receive at par and accrued interest certificates of indebtedness issued under Section 6 of the Act entitled "An Act to authorize an issue of bonds to meet expenditures for the National security and defense, and for the purpose of assisting in the prosecution of the war, to extend credit to foreign governments, and for other purposes," approved April 24, 1917, and any subsequent act or acts. The tax was required to be payable at or before the maturity of the certificates (T. D. 2656.) The amount at par and accrued interest, of the Treasury certificates of indebtedness presented by any taxpayer could not exceed the amount of taxes to be paid by him. Deposits of certificates of indebtedness and interest were made in the Federal Reserve banks of the districts in which collectors were located. (T. D. 2639.)

taxes during such time, and under such regulations, as the Commissioner, with the approval of the Secretary shall prescribe; but if a check so received is not paid by the bank on which it is drawn, the person by whom such check has been tendered shall remain liable for the payment of the tax and for all legal penalties and additions the same as if such check had not been tendered.[48] The date on which the collector receives an uncertified check in payment of the tax is considered the date of payment, unless the check is returned dishonored.[49] If payment is made by check the taxpayer as a precaution should draw the check for such amount as to cover any collection charges by the bank, in order that the net amount received by the government may be the full amount of tax due, that is, checks must be collectible at par, and taxpayers who are not sure that their checks will be paid at par, should write beneath the amount the words "without deduction for exchange" or the words "with exchange." Collectors are not required to examine all checks to see whether or not they are collectible at par, but stamp on the face of each the words "this check is in payment of an obligation to the United States and must be paid at par. No protest." If the bank on which the check is drawn should refuse to pay it at par, it will be returned through the depositary bank and will be treated in the same manner as a bad check. If any check is returned unpaid, it will be held in suspense a few days, during which time the collector will make an effort to recover the amount from the taxpayer. If the amount is recovered, the bad check will be returned to the drawer; if it is not recovered, the collector will proceed to collect the taxes by the usual methods, as though no check had been given.[50] In the payment of the tax the fractional part of a cent is disregarded unless it amounts

48 Revenue Act of 1918, § 1314. See Act of October 3, 1917 (Public No. 50.) § 1010.

49 T. D. 2627.

50 T. D. 2666.

to a half cent or more, in which case the fraction is increased to one cent.[51]

Excess Payment of Tax. If upon examination of any return made pursuant to the 1909 Law, the 1913 Law, the 1916 Law, as amended, the 1917 Law, and the Revenue Act of 1918 it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, the amount of such excess shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return and any balance of such excess shall be immediately refunded to the taxpayer. No such credit or refund will be allowed or made, however, after five years from the date when the return was due, unless before the expiration of such five years, a claim therefor is filed by the taxpayer.[52]

Recovery of Taxes Paid. Taxes erroneously paid or illegally exacted may on occasion be recovered in either of two ways: (1) from the Commissioner, and (2) by an action at law against the government or the collector who received payment thereof. Generally speaking and subject to the exceptions and definitions noted in the following paragraphs, two elements are essential to the taxpayer's right of recovery: (1) he must have protested against the assessment [53] or collection of the tax sought to be recovered, and (2) such tax must have been paid under some form and degree of duress or coercion.

RECOVERY OF TAXES FROM COMMISSIONER OF INTERNAL REVENUE. The universally recognized principle that an

[51] Revenue Act of 1918, § 1313. See Reg. 33 Rev., Art. 41.

[52] Revenue Act of 1918, § 252. The rule stated in the text prevails notwithstanding R. S., § 3228. Prior to the enactment of this provision an excess payment of tax in one year could not be offset against an assessment of tax for a subsequent year. Reg. 33 Rev., Art. 39.

[53] It has been held that a protest against the assessment is sufficient since any protest against the collection would be unavailing. The law does not require a person to do what can be of no effect. Adams v. U. S., 1 Ct. Cl. 306.

action cannot be maintained for the recovery of money paid in discharge of a tax illegally assessed, unless payment was made under protest has been held by the Commissioner and other officers of the Department to be too technical and too exacting for application to the refund of taxes under Section 3220 of the Revised Statutes,[54] and it would seem that a protest is not necessary to recover taxes from the Commissioner. But such a protest is essential if suit is to be maintained against an *adverse* decision of the Commissioner.[55]

Recovery by Action at Law. The two above mentioned essentials or conditions to the right to recover taxes erroneously paid or illegally exacted are ordinarily requisite when recovery is sought by means of an action at law, as contradistinguished from an application to the Commissioner for a refund. There is some irreconcilable conflict between various dicta, if not decisions, of the Supreme Court and the lower federal courts in considering the nature of and necessity for a protest and duress in regard to the recovery of internal revenue taxes, and while the scope of this book does not permit an exhaustive examination of the authorities, the subject is considered in the following paragraphs in the light of some of the leading cases.

Payment Under Protest. The ancient principle of the common law is of general application that taxes voluntarily paid cannot be recovered back even if they have been illegally laid or the law under which they were laid proves to be unconstitutional. The rule is founded upon the knowledge of law imputed to all taxpayers; it is also said to be one of sound public policy and quiet and good faith, operating to free the courts from the undoing of the voluntary arrangements of parties not induced by fraud, accident or excusable negligence.[56] When a voluntary payment of

[54] Real Est. Savings Bank v. U. S., 16 Ct. Cls. 335, Int. Rev. Rec. 154, affirmed 104 U. S. 728; Chesebrough v. U. S., 192 U. S. 253.

[55] Chesebrough v. U. S., 192 U. S. 253.

[56] Cooley on Taxation (Third Edition) Vol. II, Ch. XXIV, Page 1495.

taxes is spoken of, the word "voluntary" is not used in its ordinary and popular sense.[57] The purpose of paying a tax under protest is, briefly, to preserve the taxpayer's rights to recover the tax should the assessment thereof prove to be wrongful or excessive, or the law under which it was laid void and unconstitutional. Since it is usually held that the making of a protest and the existence of duress are concomitant conditions to any recovery of taxes which have been paid, the necessity for a protest will be more fully discussed in a later paragraph. It appears that a collector is not personally liable for taxes if no protest or objection is made to their collection by him.[58]

PROTEST AT TIME OF FILING RETURN. It does not seem essential, although it may be a wise precaution, also to protest at the time of filing the return upon which the assessment is based.

FORM OF PROTEST. There is no statutory requirement that a protest against the assessment and collection of internal revenue taxes be in writing.[59] A written protest is, of course, better evidence. A protest against paying the tax includes the penalties without specific mention of the latter.[60] In one case in which a corporation had been assessed for taxes and the same were not paid, a writ of distraint was issued by the collector, and, the corporation having been notified that the tax would be collected by levy, the deputy collector counted out and took from a representative of the company a sufficient amount to pay the tax against verbal protest at the time. A written notice of protest was then served in which the corporation denied

[57] In many of the cases cited hereafter in which the payment involved was held to be voluntary, the payment was most unwillingly and reluctantly made.

[58] Commissioners, etc., v. Buckner, 48 Fed. 533.

[59] Wright v. Blakeslee, 101 U. S. 174; Stewart v. Barnes, 153 U. S. 456; Swift v. U. S., 111 U. S. 22; Shaefer v. Ketchum, 21 Fed. Cas. No. 12,693. In this respect the rule in regard to internal revenue taxes differs from that in regard to customs in which case a protest must be in writing.

[60] Wright v. Blakeslee, 101 U. S. 174.

that it was liable to the tax. The court held that the protest was sufficient.[61] Under the 1909 Law the Treasury Department ruled that no form of protest was prescribed, that any form of protest would be sufficient if filed before payment of the tax, and that the right of protest was not to be denied.[62]

PROTEST ALONE NOT SUFFICIENT. A protest is used to give effect to attending circumstances; it gives notice that the payment is not to be considered as admitting the right of the taxing power to make demand for or to collect the tax in question. But as appears in the next paragraph, there must usually be duress or coercion, and if payment is made under protest alone without some form or degree of compulsion, the payment may be considered voluntary notwithstanding a protest was made.[63] It has been stated:[64] "Though there is some conflict in the dicta of the Supreme Court, the true doctrine seems to be that when taxes are paid under protest or with notice that the payer contends that they are illegal and intends to institute suit to compel their repayment, a sufficient foundation for such a suit to recover has been established." This statement is difficult to reconcile with the authorities cited in the next paragraph.

Duress. The general rule is that where a party pays an illegal demand, with full knowledge of all the facts rendering it illegal, without an immediate and urgent necessity therefor, to release his person or property from detention,

61 Abrast Realty Co. v. Maxwell, 206 Fed. 333.
62 T. D. 1675.
63 Lamborn v. Comm'rs, 97 U. S. 181; Merck v. Treat, 202 Fed. 133.
64 Herold v. Kahn, 159 Fed. 608. This remark of the court seems to be mere dicta since in the first place, the tax involved was paid under a mistake of fact and in the second place, there was probably duress in the notice sent by the collector stating that unless the tax was paid, "it will be my duty to collect the same with a penalty * * *" (See next paragraph). The case of Beers v. Moffat, 192 Fed. 984, contains the same doctrine, but recovery was denied because there was no protest or demurrer to the legality of the tax or its payment.

or to prevent an immediate seizure of his person or property, such payment must be deemed voluntary, and cannot be recovered back.[65] It will be noted that a voluntary payment is among other things a payment "with full knowledge of all the facts rendering it illegal." A payment made without such knowledge may under certain circumstances be recovered, but not on the theory of duress. The yielding to paramount taxing authority involved in the payment of a tax under duress or coercion is quite different from a payment made under a mistake of fact; that is, a payment made when such full knowledge is wanting. This distinction is illustrated by a case[66] in which at the time certain executors paid an internal revenue inheritance tax on a life estate under protest, they had no knowledge that the life tenant had died and that the life estate had, therefore, terminated so that it was improper to use life tables to determine the value of such life estate. When knowledge is thus spoken of, however, the reference is to knowlelge of facts, and not knowledge of law, which all taxpayers are presumed to have.[67] If a payment is made under a mistake of law, no relief exists. Thus in one case an importer who formally entered goods imported from Porto Rico and purchased the required stamps without protest or objection or duress in the belief that the tax was lawfully due, although the goods were not in fact lawfully taxable, was held to have made his own interpretation of law and his payment of tax was held voluntary.[68] Thus a tax paid under a statute later declared unconstitutional cannot be recovered on the theory of mistake if voluntarily paid, since the mistake is one of law.[69] It has been stated that

65 Little v. Bowers, 134 U. S. 547; Railroad Co. v. Comm'rs, 98 U. S. 541; Lamborn v. Comm'rs, 97 U. S. 181.

66 Kahn v. Herold, 147 Fed. 575, affirmed 159 Fed. 608.

67 Lamborn v. Comm'rs, 97 U. S. 181.

68 Newhall v. Jordan, 149 Fed. 586. See, however, Elliott v. Swartwout, 10 Pet. 137; Bend v. Hoyt, 13 Pet. 266.

69 Lamborn v. Comm'rs, 97 U. S. 181. In Chesebrough v. U. S., 192 U. S. 253, and U. S. v. N. Y. & Cuba Mail S. S. Co., 200 U. S. 488, the constitutionality of the acts imposing the tax was attacked,

taxes illegally assessed and paid may always be recovered back if the collector understands from the payer that the taxes are regarded as illegal and that suit will be instituted to compel the refunding of them.[70] In the case containing this doctrine the tax recovered was one on thimble-skeins and pipe-boxes of iron which were exempt. The tax, therefore, was paid under a mistake of law and although the facts are only briefly reported, there seems to have been an absence of such duress or coercion as to make the payment an involuntary one. The same absence of duress or coercion appears in other early cases.[71] In a suit to recover

but the court (except the lower court in the Chesebrough case which was reversed) did not find it necessary to consider such constitutionality since the payments were held to be voluntary and the mistake in making payments, if any was one of law. See also Union Pacific Co. v. Dodge, 98 U. S. 541.

70 Erskine v. Van Arsdale, 15 Wall. 75. This statement was contained in a charge of the lower court to the jury which was sustained by the Supreme Court. (See next note.)

71 Elliott v. Swartwout, 10 Pet. 137; Bend v. Hoyt, 13 Pet. 266; Philadelphia v. Collector, 5 Wall. 720; Collector v. Hubbard, 12 Wall. 13. In the first two of these cases, which were customs cases, the payments were made to release goods held for duties on imports and the protest became necessary in order to show that the legality of the demand was not admitted when payment was made. The recovery rested upon the fact that the payment was made to release property from detention and the protest saved rights which grew out of that fact. The detention of property under such circumstances would seem to constitute duress. (See, however, Newhall v. Jordan, 149 Fed. 586 in which it was conceded that the importer could not have obtained possession of the goods without making the payment, recovery being still denied. See also U. S. v. N. Y. & Cuba S. S. Co., 200 U. S. 488.) In the third and fourth of these cases, which were internal revenue cases, recovery was based upon the ground that the several provisions in the acts under which the taxes were imposed warranted the conclusion as a necessary implication that Congress intended to give the taxpayer the remedy to recover, it being expressly so stated in the fourth case. In the case of Erskine v. Van Arsdale, 15 Wall. 75, (see note 70) probably falls within the same class as the third and fourth cases. It is to be noted that the Court in Herold v. Kahn, 159 Fed. 608, uses Philadelphia v. Collector, 5 Wall. 720 as one of its authorities for the statement which has been criticised above. (See note 64.)

back real property taxes paid by the Union Pacific Railroad Company to Dodge County, Nebraska, it appeared that in due time the tax lists with warrants attached for their collection were delivered to the treasurer of the County. These warrants authorized the treasurer, in order to enforce collection, to seize the personal property of any persons making default in the payment of any taxes charged upon the lists. No demand for taxes was necessary, it being the duty of every person subject to taxation to attend at the treasurer's office and make payment. The company so attended and made payment filing at the same time a protest in general terms containing no specification of alleged illegality, or designation of particular property as wrongfully included in the assessment. Although the company had personal property in the county which might have been seized, no special effort had been made or active steps taken to enforce collection, and no other notice given by the taxing authorities than such as the law implies. Three years afterward a case was decided which was supposed to hold that the particular lands were exempt from taxation, whereupon the company brought suit to recover the taxes involved. It was held that no such immediate and urgent necessity for the payment of the taxes in controversy existed as to imply that such payment was made under compulsion.[72] In what is perhaps the leading case [73] on the subject of duress, stamps were purchased from the collector of internal revenue for the purpose of affixing

[72] Union Pacific Co. v. Dodge, 98 U. S. 541. The provisions of the state statute levying the tax involved in this case do not clearly appear, but it may well be that the rule as to what constitutes duress in cases of real property taxation may vary from the rule in cases arising under the internal revenue laws. For instance, the owner of real property always has his action of ejectment. To the same general effect see Simons v. U. S., 19 Ct. Cls. 601, where the taxpayer paid the tax to obtain possession of his property; Christie Street Co. v. U. S., 126 Fed. 991 (internal revenue cases).

[73] Chesebrough v. U. S., 192 U. S. 253. The court cites Little v. Bowers, 134 U. S. 549; and Union Pacific Co. v. Dodge, 98 U. S. 541 in support of its conclusion.

them to a deed to a building company. The collector was not informed at the time of the purchase of this particular purpose and no intimation, written or oral, was given him of any claim by the purchaser of the stamps that the law requiring the affixing of the stamps was unconstitutional and that he was making the purchase under duress. About 19 months after the payment, an application was made to the Commissioner for a refund which was denied. It was held that no duress existed. While this case is cited as an authority for the general rule stated at the beginning of this paragraph and does not appear ever to have been questioned, its facts do not even disclose the making of a protest,[74] and the only duress claimed did not come from the government or its agents but from a third party.[75] Beyond this and in the light of its facts it is not, strictly speaking, an authority upon the question of duress and the court intimates that the rule as to duress is less rigorous on some occasions than on others.[76] In another case,[77]

[74] The court held that an application to the Commissioner of Internal Revenue under Section 3220 was not the statutory equivalent of a common law protest or notice of suit.

[75] It appeared that the vendee was unwilling to accept an unstamped conveyance and that stamps were affixed in order to complete the transaction and obtain the consideration. But the court said that "if that constituted duress as between Chesebrough and his building company it was a matter with which the collector had nothing to do."

[76] Note the following language of the court: "At the same time, when taxes are paid under protest that they are being illegally exacted, or with notice that the payer contends that they are illegal, and intends to institute suit to compel their repayment, a recovery in such suit may, *on occasion*, be had, although generally speaking, even a protest or notice will not avail if the payment be made voluntarily. * * * As we have said, the purchase of these stamps was purely voluntary, and if, *notwithstanding, recovery could be had, it could only be on protest or notice*, and there was none such here, written or verbal, formal or informal."

[77] U. S. v. N. Y. & Cuba S. S. Co., 200 U. S. 488. In this case as in Chesebrough v. U. S., 192 U. S. 253 the collector was not informed at the time of the purchase of the particular purpose for which the stamps were to be used, and no intimation was given him, written

however, duress as to the stamp tax on manifests of cargoes was claimed in that clearance papers for vessels bound to foreign ports could not be obtained without stamped manifests without which in turn such vessels would be prevented from sailing and their masters liable to a penalty. The court held that such facts did not constitute duress. Further doubt has been thrown upon this entire question by a comparatively recent case,[78] in which the taxing statute in controversy contained self-executing or automatic provisions for its enforcement, whereby corporations failing to pay the tax forfeited their rights to do business within the state and incurred a penalty. The court said in part: "It is reasonable that a man who denies the legality of a tax should have a clear and certain remedy. The rule being established that, apart from special circumstances, he cannot interfere by injunction with the state's collection of its revenues, an action at law to recover back what he has paid is the alternative left. Of course, we are speaking of those cases where the state is not put to an action if the citizen refuses to pay. In these latter he can interpose his objections by way of defense; but when, as is common, the state has a more summary remedy, such as distress, and the party indicates by protest that he is yielding to what he cannot prevent, courts sometimes, perhaps, have been a little too slow to recognize the implied duress under which payment is made. But even if the state is driven to an action, if, at the same time, the citizen is put at a serious disadvantage in the assertion of his legal, in this case of his constitutional, rights, by defense in the suit, justice may require that he should be at liberty to avoid those disad-

or oral, that the taxpayer claimed that the law regarding such stamps was unconstitutional and that it was making the purchase under duress. The court said that all determining conditions were the same as in the Cheseb rough case.

[78] Atchison v. O'Connor, 223 U. S. 280. See also Gaar, Scott, & Co. v. Shannon, 223 U. S. 468, in which the court said in part: "Neither a statute imposing a tax, nor the execution thereunder, nor a mere demand for payment, is treated as duress. It does not necessarily follow that there will be *duress of goods.*"

vantages by paying promptly and bringing suit on his side. He is entitled to assert his supposed right on reasonably equal terms.'' A clearer definition than exists at present of the nature of, and necessity for a protest and duress in regard to the recovery of internal revenue taxes would be of material assistance both to the taxpayer and the government, since the present uncertainty, instead of freeing the courts from the undoing of the voluntary arrangements of parties not induced by fraud, accident or excusable negligence, is calculated to fill the courts with questions which do not go to the merits of taxation controversies. The more liberal rule of implied duress suggested by the Supreme Court in the case [79] referred to above, if properly extended and applied, would relieve many taxpayers objecting in good faith to the imposition of a tax from the necessity of incurring a penalty in order to come technically within the present rule as to involuntary payments.

PAYMENT AFTER RECEIPT OF NOTICE OF ASSESSMENT. Clearly a payment upon the receipt of a notice of assessment sent pursuant to the 1916 Law, the use of which does not seem to be contemplated by the Revenue Act of 1918, would not be a payment under duress within the rule of the cases referred to above, since that notice neither demanded the tax nor contained any threat of penalties.

PAYMENT AFTER RECEIPT OF FIRST NOTICE AND DEMAND FOR TAX. The earlier form [80] of notice and demand for tax

[79] Atchison v. O'Connor, 223 U. S. 280. Almost all taxing statutes now contain summary and other drastic remedies for failure to pay the tax at the appointed time. Under the presumption that officers of the law will fulfill their duties a considerable extension of the doctrine of duress implied from a statute imposing a tax might well be made without detriment to the government's interests. It is seldom that the government and the taxpayer are on equal terms or that the latter has any choice but to do what the Government officials require. Indeed, the only alternative of a taxpayer may sometimes be as in Swift v. U. S., 111 U. S. 22, to submit to an illegal exaction or discontinue business. It would seem that a clear protest should always be required.

[80] Form 17.

contained the following language: "Demand is here made for this tax. * * * If this tax is not in my hands for deposit before the close of business of the day above specified it will become my duty, under the law, to collect the same together with 5 per centum additional, and interest at 1 per centum per month until paid." The form [81] in use since 1916 contains the following language: "If payment is not made within ten days from the above date, it will be my duty to collect the same with costs by seizure and sale of property." In a case in which a notice very similar in form to the former of the above notices and containing a threat to collect penalties and interest was served upon the taxpayer it was held that payment was clearly involuntary and under duress.[82] In another case [83] arising under the 1913 Law the Supreme Court allowed recovery when payment was made after receipt by the taxpayer of the first of the above forms of notice. It seems that the present form of notice and demand, although not containing an express threat to collect the 5% penalty and interest, but containing a statement that such penalty and interest will accrue, is sufficient to constitute a payment made thereafter involuntary.

PAYMENT AFTER RECEIPT OF SECOND NOTICE AND DEMAND FOR TAX. There can be no doubt that payment upon receiving the second notice and demand is clearly payment under duress, since that notice threatens the seizure and sale of the taxpayer's property to satisfy the tax, penalty, interest and costs.[84] If the taxpayer delays payment until the receipt of such notice, in order that it may be shown that payment was clearly made under duress, penalty and

81 Form 1-17.

82 Herold v. Kahn, 159 Fed. 608.

83 Gulf Oil Co. v. Lewellyn, 248 U. S. 71, reversing 245 Fed. 1, which had reversed 242 Fed. 709. In a case arising under the 1909 Corporation Excise Tax Law it was held that payment after a notice to the effect that if the tax together with interest was not paid, the collector would take steps to collect the same with penalties was involuntary. (Cambria Steel Co. v. McCoach, 225 Fed. 278.)

84 See Form 1-21 A or 1-21 B.

interest must also be paid. It is a wise precaution in such case to protest not only against payment of the tax but also against payment of such penalty and interest as well.

Receipts for Payment of Tax. Every collector to whom any payment of any tax is made is on request required to give to the taxpayer a full written or printed receipt, stating the amount paid and the particular account for which the payment was made.[85]

FORM OF RECEIPT. The only official receipt for taxes that collectors may sign under the law is the form prescribed by the Department. However, there is no objection, on the part of the Department, to collectors signing commercial receipts or voucher checks, but they should in signing such receipts or vouchers write or stamp across the face thereof "not an official receipt." The official receipt must also be furnished, and an unofficial receipt is not in any manner binding on the government and will not be received by it as evidence of payment of the tax.[86] Deputy collectors must give taxpayers, at the time of the payment, a personal receipt stating that the amount of payment has been received to be forwarded to the collector.[87] Under present rulings collectors will give receipts only on request. In the case of payments by check or money order the canceled check or money order receipt is usually a sufficient receipt. In case of payments by cash the taxpayer should in every instance require receipt.

TAXES WITHHELD AT THE SOURCE. Whenever any debtor pays taxes withheld at the source on account of payments made or to be made by him to separate creditors, the collector is required, on request, to give a separate receipt for the tax paid on account of each creditor so that the debtor can conveniently produce such receipts severally to his creditors in satisfaction of their respective demands up to the amounts stated in the receipts. Such receipts are suf-

85 Revenue Act of 1918, § 251. Prior to the enactment of this section receipts were issued even when they were not requested.

86 T. D. 2226.

87 T. D. 2341.

ficient evidence in favor of such debtor to justify him in withholding from his next payment to his creditor the amount stated in the receipt. The creditor may, upon giving the debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting and specifying the amount of tax paid as a further satisfaction of the debt to that amount, require the surrender to him of the collector's receipt.[88]

Abatement and Refund. The taxpayer may file a claim for abatement of an assessment which he thinks is erroneous after the assessment has been made and before the tax is paid, or may file a claim for refund of a tax which he thinks has been erroneously assessed after the tax is paid. A further discussion of this subject is contained in a later chapter on abatement and refund.[89]

Additional Assessment. The 1916 Law provided[90] that "in cases of refusal or neglect to make a return and in cases of erroneous, false, or fraudulent returns, the Commissioner shall, upon the discovery thereof, at any time within three years after the return is due, or has been made, make a return upon information obtained as provided for in the law, or require the necessary corrections to be made, and in such cases the assessment made by the Commissioner thereon shall be paid by the taxpayer immediately upon notification of the amount of such assessment." The usual ten day period of grace, however, applied to such assessments as well as to the regular assessments. The same law provided:[91] "If any person

88 Revenue Act of 1918, § 251. See Chapter 40 on Collection of the Tax at the Source.

89 See Chapter 38 on Abatement and Refund.

90 Revenue Act of 1916, §§ 9 (a), 14 (a).

91 R. S. 3176, as amended by the Revenue Act of 1916. Although the Commissioner of Internal Revenue had power summarily to assess the tax upon discovery of income which had not been reported, yet if such discovery was made prior to the day on which the tax was due (June 15th or in the case of the corporations filing for their fiscal year 165 days after the closing of the fiscal year) the tax could not be summarily assessed but might be paid at any

* * * fails to make and file a return or list at the time prescribed by law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. Any return or list so made and subscribed by a collector or deputy collector shall be *prima facie* good and sufficient for all legal purposes. * * * The Commissioner of Internal Revenue shall assess all taxes, other than stamp taxes, as to which returns or lists are so made by a collector or deputy collector." The duplication and conflict of these provisions have been removed in the Revenue Act of 1918. It is now provided:[92] "If any person * * * fails to make and file a return or list at the time prescribed by law or by regulations made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner or by a collector or deputy collector and approved by the Commissioner, shall be *prima facie* good and sufficient for all legal purposes. * * * The Commissioner of Internal Revenue shall determine and assess all taxes other than stamp taxes, as to which returns or lists are so made under the provisions of this section." The Revenue Act of 1918 also provides[93] that "except in the

time before the regular due date with an additional period of ten days of grace. (T. D. 2003.) Where a summary assessment was made after the regular due date, the tax was due immediately upon notice and demand given by the collector. (Reg. 33, Arts. 177 and 184.)

[92] R. S., § 3176, as amended by the Revenue Act of 1918. The italicized words were added by the amendment.

[93] Revenue Act of 1918, § 250 (d).

case of false or fraudulent returns *with intent to evade the tax*, the amount of tax due under any return shall be determined and assessed by the Commissioner within five years after the return was due or was made, and no suit or proceeding for the collection of any tax shall be begun after the expiration of five years after the date when the return was due or made. In the case of such false or fraudulent returns, the amount of tax due may be determined at any time after the return is filed, and the tax may be collected at any time after it becomes due." In addition to removing the inconsistency of the two sections providing for summary assessment, the two last quoted provisions make three changes in the law. In the first place, the rule that the limitation of time is upon the discovery of the error by the Commissioner and not upon the making of the additional assessment,[94] is changed, and the limitation is now upon the making of the assessment.[95] In the second place the limitation itself is extended from three to five years.[96] In the third place, the limitation which was held formerly to apply only to summary assessments[97] is now expressly made also applicable to "suits or proceedings for the collection of any tax."[98] Additional assessment may still be made where the erroneous return is due to an honest mistake, and where the mistake is not discovered until after the tax is assessed and has been paid in the regular course.[99]

Amended Returns. Under the 1916 Law where an individual or a fiduciary or a withholding agent was found subject to a further tax as a result of the audit of his

94 Eliot Nat. Bank v. Gill, 210 Fed. 933, affirmed 218 Fed. 600.

95 Revenue Act of 1918, § 250 (d).

96 Compare Revenue Act of 1918, § 250 (d) with Revenue Act of 1916, §§ 9 (a) and 14 (a).

97 U. S. v. Minneapolis Threshing Mach. Co., 220 Fed. 1019.

98 Revenue Act of 1918, § 250 (d). Compare this section with Revenue Act of 1916, §§ 9 (a) and 14 (a).

99 Eliot Nat. Bank v. Gill, 218 Fed. 600; Woods v. Lewellyn, 252 Fed. 106. The same words "false or fraudulent" are still used in R. S., § 3176, as amended by the Revenue Act of 1918, which

return, or an investigation made by a revenue agent, it was not necessary to file an amended return, but the delinquent was advised by letter of the amount of additional tax to be assessed and the reasons for making such assessments.[100] In the case of corporations amended returns were required, but the examining officers of the Government were required to give the officers of the corporation the fullest opportunity to make any investigation that might be desired prior to signing the amended returns, provided such investigation did not cover an unreasonable length of time.[101].

Five-Year Limitation on Summary Assessment. The 1916 Law authorized the Commissioner to make a summary assessment of the tax on undisclosed income, if the discovery was made within three years after the return in which such income should have been reported was due.[102] The assessment was not required to be made within three years, so long as the discovery was made within that time.[103]

were held in the above cases to include returns honestly incorrect and thus to give the Commissioner power to make summary assessments when such returns had been filed.

100 Mimeograph letter No. 1232 to Collectors.

101 Letter from Treasury Department dated February 2, 1915; I. T. S. 1918, ¶ 1811.

102 Revenue Act of 1916, §§ 9 (a) and 14 (a).

103 Eliot National Bank v. Gill, 218 Fed. 600. While the Government was fully authorized under the 1916 Law to recover taxes by suit upon discovery of liability to original or additional tax after the three-year period, the Treasury Department preferred that the collection should be made in the ordinary statutory method, that is, as a result of a formal assessment. In order that this might be done, taxpayers were requested to make amended returns and to execute waivers of the three-year statutory limitation. In executing such waiver, the taxpayers forfeited none of their rights and assumed no liability to any penalty that might not have been enforced against them in the absence of such waiver. If the taxpayer, against whom an additional tax liability was discovered, formally accepted the findings of the examining officer and agreed voluntarily to pay the tax, this amounted to a waiver and neither amended returns nor waivers were required. (Mimeograph Letter to Collectors, No. 1192.) There was apparently no objection to a

The three years' limitation in this provision was not a limitation upon the right of the government to sue for unpaid taxes, but was at most a limitation upon the right of the collecting officers to make assessment and enforce the payment by the summary statutory proceedings.[104] The present limitation is five years; the limitation is upon the making of the assessment, and is applicable to the right of the government to sue as well as the additional assessment. In computing the five year period, March 15, the date on which the returns should have been filed, or were filed in due course, should be excluded. The more modern general rule[105] in the interpretation of statutes, where time is to be computed from a particular day, is to exclude the day thus designated and to include the last day of the specified period.[106] The limitation discussed in this paragraph does not apply in case of false or fraudulent returns with intent to evade the tax.[107]

Refund of Taxes Collected on Second Assessment. When a second assessment is made in case of any list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, such assessment shall not be remitted, nor such taxes collected under such assessment refunded or paid back or recovered by any suit unless it is proved that such list, statement, or return was

taxpayer signing a waiver where additional tax liability was discovered after the expiration of the three-year period, providing he did not question the legality of the assessment. The result of signing a waiver was to compel him to pay the tax under protest and sue for its recovery, while if a waiver was not signed, the Government became the plaintiff in action to collect such tax. Where the limitation of the statute as to assessment had run and a written waiver of exemption from assessment was given by the taxpayer, the ad-valorem penalty of 50% addition to tax, was not assessed for delinquency in filing a return. (Reg. 33 Rev., Art. 52.)

104 U. S. v. Grand Rapids & Indiana Ry. Co., 239 Fed. 153.

105 McCullogh v. Hopper, 47 N. J. L. 189.

106 Eliot National Bank v. Gill, 218 Fed. 600; National Bank of Commerce v. Allen, 223 Fed. 472.

107 Revenue Act of 1918, § 250 (d).

not wilfully false or fraudulent, and did not contain any wilful understatement or undervaluation.[108]

Interest on Delinquent Taxes. Interest at the rate of 1% per month is added to taxes unpaid after notice and demand, except when the tax is the subject of a *bona fide* claim for abatement, in which case it is at the rate of one-half of one per cent. per month. Interest on deferred installments is at the rate of one-half of one per cent. per month.[109] Where penalty has been added to a tax, interest is computed on tax and penalty,[110] and is recoverable as interest, not as penalty.[111]

Suits for Collection of Taxes. Prior to the Revenue Act of 1918 none of the statutes of limitation, such as the limitation of three years (now five years) as to summary assessments contained in the various income tax laws is applicable to suits by the United States to recover unpaid taxes or the balance of any unpaid tax, but at most was a limitation upon the right of collecting officers to make assessments and to enforce the tax by summary statutory proceedings.[112] This rule is now changed and the statute of limitation of five years is applicable to such suits.[113] As to taxes which have accrued under the 1916 Law and prior laws the Government may without limitation as to time bring suit, whether the taxes in question have been assessed or not, and whether or not they are assessable. The only qualification upon this right to resort to a plenary suit in the absence of an assessment is that the tax must be ascertainable and determinable, on evidence, by a court, and a tax of fixed percentage on a subject or ob-

108 R. S. § 3225 as amended by the Revenue Act of 1918. This amendment combines the former proviso clause of R. S. § 3220 with R. S. § 3225 in its previous form; and also by the insertion of the words "wilful" and "wilfully" is a statutory enactment of Northwestern Ins. Co. v. Fink, 248 Fed. 568. See p. 608.

109 Revenue Act of 1918, § 250 (e).

110 T. D. 870, Feb. 27, 1905.

111 U. S. v. Guest, 143 Fed. 456.

112 U. S. v. Minneapolis Threshing Machine Co., 229 Fed. 1019.

113 Revenue Act of 1918, § 250 (d).

ject which is so definitely described in the statute that its amount or value can be so ascertained or determined, may be recovered in an action though it has never been fixed by an assessment. The action by the government to recover unpaid taxes may take the form of *indebitatus assumpsit,* or a common-law action of debt,[114] and should be brought in the name of the Unites States in the district within which the liability to the taxes is incurred or where the party from whom the taxes are due resides at the time of the commencement of the action. Interest on the taxes sued for runs from the time the taxes were due.[115]

Lien for Unpaid Taxes. If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount shall be a lien in favor of the United States from the time when the assessment-list was received by the collector, except when otherwise provided, until paid, with the interest, penalties, and costs that may accrue in addition thereto, upon all property and rights to property belonging to such person.[116]

NOTICE OF LIEN. The government's lien for collection of taxes is not valid as against any mortgagee, purchaser or judgment-creditor, until notice of such lien has been filed by the collector in the office of the Clerk of the District Court of the District within which the property subject to such lien is situated, and is not valid in a state which by appropriate legislation authorizes the filing of such notice in the office of the registrar or recorder of deeds of the counties of that state, unless the notice is filed in the office of such registrar or recorder of deeds of the county (or parish in the State of Louisiana) within which

114 U. S. v. Nashville, etc., Ry. Co., T. D. 2697; U. S. v. Grand Rapids, etc., Ry. Co. (and cases cited) 239 Fed. 153; U. S. v. Minneapolis Threshing Mach. Co., 229 Fed. 1019; Dollar Savings Bank v. U. S., 19 Wall. 227; King v. U. S., 99 U. S. 229; U. S. v. Chamberlin, 219 U. S. 250; U. S. v. Little Miami Co., 1 Fed. 700.

115 U. S. v. Erie R. R., 106 U. S. 327.

116 R. S., § 3186.

the property subject to the lien is situated.[117] A lien for taxes is not similar to the lien of an ordinary incumbrance. It is not displaced by a sale under a pre-existing judgment or decree, unless otherwise directed by statute. It attaches to the *res* without regard to individual ownership, and when it is enforced by sale pursuant to the statute prescribing the mode of assessing and collecting taxes, the purchaser takes a valid and unimpeachable title.[118] The lien may be enforced against any transferee of real or personal property of the taxpayer (except a mortgagee, purchaser or judgment creditor) with respect to property transferred after the lien attaches, that is, after the filing of the list with the collector, although the transferee had no notice of the lien.[119] To create a lien demand must be made for a specific amount; all steps required by law must be pursued strictly. The lien requires an assessment, a notice of the tax due, and a specific demand upon the in-

117 Act of March 4, 1913, amending R. S., § 3186. This amendment seems to have been made in response to suggestions of the American Bar Association (Part 1, Proceedings American Bar Ass'n, 106, p. 598) and of the court in U. S. v. Curry, 201 Fed. 371, in which the harshness of enforcing the lien against innocent purchasers without knowledge or notice of the lien was emphasized. (See also U. S. v. Pacific R. R., 1 Fed. 97.) The suggestion was made by Judge Rose in the Curry case in the following language: "It would seem that by a comparatively slight change of the statute law the rights of the United States could be sufficiently protected without endangering the interests of other persons. The collector of internal revenue at the time he makes a demand upon the taxpayer might be required to transmit a copy of the demand to some officer in which judgments and other recognized liens upon real estate are recorded and the records of which are consequently carefully examined by conveyancers." The lien was held to be superior to that of any one acquiring any interest in the property after the date of demand and unaffected by the fact that a subsequent purchaser became such without knowledge of the lien or claim of the government in the following cases: U. S. v. Pacific R. R., 1 Fed. 97; U. S. v. Turner, 28 Fed. Cas. No. 16,548; U. S. v. Snyder, 149 U. S. 210; U. S. v. Blacklock, 208 U. S. 75.

118 Osterberg v. Union Trust Co., 93 U. S. 424.

119 U. S. v. Curry, 201 Fed. 371 (and cases cited) is modified by the amendment of R. S., § 3186.

dividual taxpayer for payment.[120] The government is not compelled to resort to distraint and sale of chattels and personal effects of a taxpayer, before instituting proceedings to enforce a lien on the taxpayer's real estate and leaseholds.[121]

TIME WHEN LIEN ATTACHES. The statute expressly provides that a lien for unpaid taxes in favor of the United States shall attach from the time when the assessment-list was received by the collector, except when otherwise provided.[122] No other provision seems to be applicable to the income tax law. The Revenue Act of 1918 provides that "all administrative special or stamp provisions of law including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this Act." But under the method of collection prescribed by that law it is uncertain when the assessment list is intended to reach the collector.[123] In the case of a corporation which has distributed its assets prior to the time when a lien would attach thereto, the government may proceed to collect the tax as a general creditor.[124]

Taxes Collectible by Distraint. If any person liable to pay any taxes neglects or refuses to pay the same within ten days after notice and demand, it shall be lawful for the collector or his deputy collector to collect the taxes, with the 5% penalty, and interest at the rate of 1% per month, by distraint and sale of the goods, chattels or effects, including stocks, securities, and evidences of debt, of the person delinquent.[125] This section of the statute exempts certain property from distraint in the case of the head of a family.[126] Extensive provision is made in the

120 U. S. v. Pacific R. R., 1 Fed. 97; U. S. v. Allen, 14 Fed. 263.

121 U. S. v. Curry, 201 Fed. 371; Mansfield v. Excelsior Refining Co., 135 U. S. 326; U. S. v. Blacklock, 208 U. S. 75.

122 R. S., § 3186.

123 Revenue Act of 1918, § 250.

124 See Chapter 12 on Corporations.

125 R. S., § 3187.

126 Only heads of families are entitled to this exemption. (T. D.

statute for the mode of levying distraint and proceedings on distraint.[127] Collectors are enjoined against unnecessary delays in making sales and postponing sales beyond statutory periods; they are also required to make reports promptly.[128] Surplus moneys must be deposited as internal revenue collections and cannot be returned to the legal owner of the property sold.[129] In any case in which in order to enforce payment of a tax it is necessary for a collector to cause a warrant of distraint to be served, the sum of $5 is added as part of the tax.[130]

Procedure in Case of Taxpayers Contemplating Removal or Concealment of Property to Defeat Collection of Tax. If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year[131] then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner may declare the taxable period for such taxpayer terminated at the end of the calendar month then last past and cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such

1499.) The state exemption laws are inapplicable to debts due the United States—U. S. v. Howell, 9 Fed. 674.

127 R. S., § 3188 et seq.

128 T. D. 623, January 23, 1903.

129 T. D. 1373.

130 Revenue Act of 1918, § 250 (f).

131 The term "taxable year" means the calendar year or the fiscal year ending during such calendar year upon the basis of which the taxpayer's net income is computed. The first taxable year, to be called the taxable year 1918, shall be the calendar year 1918 or any fiscal year ending during the calendar year 1918.

taxes shall thereupon become immediately due and payable. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of the Commissioner, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A taxpayer who is not in default in making any return or paying income, war profits, or excess profits tax may furnish to the United States, under regulations to be prescribed by the Commissioner with the approval of the Secretary, security approved by the Commissioner that he will duly make the return next thereafter required to be filed and pay the tax next thereafter required to be paid. The Commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the above finding and declaration, provided the taxpayer has paid in full all other income, war profits, or excess-profits taxes due from him. If security is approved and accepted and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any of the above proceedings prior to the expiration of the time otherwise allowed for paying such respective taxes.[132] Under this provision it seems to be within the power of the Commissioner to declare the taxable period of a corporation terminated at the end of the calendar month preceding the month in which it is dissolved and to demand immediate payment of the tax for such taxable period and the tax for the preceding year or to require security for the payment thereof.

[132] Revenue Act of 1918, § 250 (g).

CHAPTER 36

PENALTIES AND COMPROMISES

Several penalties are contained in the law for failure to comply with its provisions and for making false and fraudulent returns. The penalties take two forms: (a) specific penalties of fines with maximum limits and imprisonment, and (b) penalties of either 5%, 25% or 50% based upon the tax. In the case of individuals specific penalties are held to attach to the person and are unenforceable after the death of such person. *Ad valorem* penalties (those based upon the tax) are enforceable regardless of the death of the owner of the income by which the penalty is measured.[1]

Suit to Enjoin Collection of Penalties. While the prohibition of suits to enjoin the collection of internal revenue taxes,[2] does not specifically include "penalties" as such, yet where penalties are authorized by the statute to be added to the tax and collected as a part of the tax, the courts will hold that the penalty is a part of the tax, and its collection cannot be enjoined.[3]

Failure to File Return. If an individual, corporation or partnership fails to file a return, the specific penalty, where the failure is not wilful, is not more than $1,000.[4] In the case of such failure to file a return or list within the time prescribed by law, or by the Commissioner or collector,

1 Reg. 33 Rev., Art. 51. See U. S. v. Theurer, 213 Fed. 960; U. S. v. Pomeroy, 152 Fed. 279, reversed on different ground, 164 Fed. 324.

2 R. S., § 3224.

3 Kohlhamer v. Smietanka, 239 Fed. 408.

4 Revenue Act of 1918, § 253.

the Commissioner also adds to the tax 25% of its amount,[5] except as set forth in the next paragraph.

EXCEPTION. When a return is filed after the time prescribed by law, and it is shown that the failure to file it was due to a reasonable cause and not to wilful neglect, the addition of 25% of the tax is not made.[6] The words "reasonable cause" have been held to be such a condition of fact as, had the taxpayer in default exercised ordinary care and prudence it would have been impracticable or impossible for him to have filed his return in the prescribed time. Delinquent returns must be accompanied by a showing of the fact alleged as reasonable cause for excuse from the 25% penalty. This showing must be made in the form of an affidavit, under oath, and should be attached to the return.[7]

Returns of Withholding Agents. Failure to make and file withholding returns on or before March 1st renders a withholding agent liable to the specific penalty of not more than $1,000 [8] unless the tax is paid by the recipient of the income.[9] If the failure of the withholding agent was fraudulent and for the purpose of evading the tax, however, he will be guilty of a misdemeanor and fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution, irrespective of whether or not the tax is paid by the recipient of the income.[10] The 25% addition to the tax for failure to make a return and the 50% addition for a wilfully false and fraudulent return are not assessed against withholding agents.[11]

Intentional Neglect or Refusal to Make Returns. Any individual, corporation or partnership wilfully refusing to make a return is guilty of a misdemeanor and subject to a

[5] R. S., § 3176, as amended by the Revenue Act of 1918.
[6] R. S., § 3176, as amended by the Revenue Act of 1918.
[7] Reg. 33 Rev., Art. 54.
[8] Revenue Act of 1918, § 253.
[9] Revenue Act of 1918, § 221 (e).
[10] Revenue Act of 1918, § 253, 221 (e).
[11] Mimeograph letter to Collectors, No. 1,265.

fine not to exceed $10,000, or to imprisonment not to exceed one year, or both, together with the costs of prosecution.[12] In case of intentional neglect or refusal to make a return, the *ad valorem* penalty of 25% of the tax is also added. The amount so added is collected at the same time and in the same manner and as part of the tax, unless the tax has been paid before the discovery of the neglect, in which case the amount so added is collected in the same manner as the tax.[13]

False Returns. The law provides that if an understatement in a return "is false or fraudulent, then, in lieu of the penalty provided by Section 3176 of the Revised Statutes, as amended, for false or fraudulent returns wilfully made, but in addition to other penalties provided by law for false or fraudulent returns there shall be added as part of the tax 50 per centum of the amount of the deficiency."[14] This provision does not seem to include returns which are

[12] Revenue Act of 1918, § 253.

[13] R. S., § 3176, as amended by the Revenue Act of 1918. Under the 1913 Law the *ad valorem* penalty of 100% was added. T. D. 1950. R. S., § 3176 as then in force did not except from the 50% penalty the case of a return filed after the time prescribed where it was shown that "the failure to file it was due to a reasonable cause and *not to wilful neglect*," an exception contained in R. S. § 3176, as amended by the 1916 Law, and the Revenue Act of 1918, and the inference of which is clear that for intentional failure to file a return only the 25% penalty should be added. Even in its 1913 Law, however, it is difficult to understand by what authority the 100% penalty was added for failure to make any return at all, even though the failure was intentional.

[14] Revenue Act of 1918, § 250. The law also provides that "in case a false or fraudulent return is wilfully made, the Commissioner shall add to the tax 50 per centum of its amount." The amount so added to any tax shall be collected at the same time and in the same manner and as part of the tax unless the tax has been paid before the discovery of the neglect, falsity or fraud, in which case the amount so added shall be collected in the same manner as the tax. R. S. § 3176, as amended by Revenue Act of 1918. Under this provision before the Revenue Act of 1918, it was held that the corresponding penalty should be added to the amount of the tax shown by the correct return. (Reg. 33 Rev., Art. 53.)

false in the sense of containing mistakes or unintentional misstatements. A return may be false, in the sense used in those sections of the law which permit summary assessments in the case of erroneous, false or fraudulent returns without being false in the sense prescribing the penalty of 50%.[15] If a return made in good faith is false in the sense of being incorrect, but such falsity is due to negligence on the part of the taxpayer, the 50% is not added, but a penalty of 5% of the total amount of any deficiency plus interest at 1% per month on the amount of the deficiency of each installment from the time such installment is due, is added. No penalty is imposed in case a return made in good faith is false in the sense of being incorrect, in the absence of fault on the part of the taxpayer.[16] In addition to the *ad valorem* penalties above enumerated for making false and fraudulent returns, a specific penalty not exceeding $1,000, or imprisonment not exceeding one year, or both, in the discretion of the court with costs of prosecution may be added.[17]

Fraudulent Returns. Where a false or fraudulent return is made, then, in addition to the other penalties provided by law for false or fraudulent returns, there shall be added as part of the tax 50% of the amount of the deficiency. This increase is only made in case the return is fraudulently false.[18]

Fine Against or Imprisonment of Officer of Corporation or Member of Partnership or Employee of Either. In case

15 Revenue Act of 1918, § 250; R. S. § 3176, as amended by Revenue Act of 1918. Eliot Nat. Bank v. Gill, 218 Fed. 600; Woods v. Lewellyn, 252 Fed. 106. See, however, U. S. v. Nashville etc. Ry. Co., T. D. 2697.

16 Revenue Act of 1918, § 250.

17 The making of a false or fraudulent return might also fall within the provisions of Section 253 of the Revenue Act of 1918 which imposes a fine of not more than $10,000 and imprisonment for not more than one year, or both, together with the costs of prosecution for wilfully attempting "in any manner to defeat or evade the tax."

18 Nat. Bank of Commerce v. Allen, 223 Fed. 472.

an officer of a corporation or member of a partnership or an employee of either, charged with the duty and responsibility of making a return, paying or collecting the tax, or supplying information at the source, wilfully refuses to make such return, pay or collect such tax, or to supply such information, or attempts in any manner to defeat or evade the tax, he is guilty of a misdemeanor and subject to a fine not to exceed $10,000, or to imprisonment not to exceed one year, or both, together with the costs of prosecution.[19]

Failure to File Information at Source. Any individual, corporation or partnership called upon to supply information at the source, who fails to do so at the time or times specified in each year, when such failure is not wilful, is liable to a penalty of not more than $1,000. If such failure to file information at the source is wilful, the delinquent is guilty of a misdemeanor and subject to a fine not to exceed $10,000, or to imprisonment not to exceed one year, or both, together with the costs of prosecution.[20]

Failure to Withhold Tax at Source. Any individual, corporation or partnership required by law to deduct and withhold the tax at the source is personally liable for the tax so required to be withheld, but if the tax is paid by the recipient of the income, it will not be collected from the withholding agent unless his failure to pay the tax is fraudulent and for the purpose of evading payment,[21] in which case the withholding agent will be subject to the same specific penalty which attaches to a failure on his part to file a return.[22] If such failure is not fraudulent or for the purpose of evading payment, but the tax is not paid by the recipient of the income, in addition to being liable personally for the tax, the withholding agent will be liable to a penalty of not more than $1,000.[23]

19 Revenue Act of 1918, § 253.
20 Revenue Act of 1918, § 253.
21 Revenue Act of 1918, § 221 (c) and (e).
22 Revenue Act of 1918, § 221 (e).
23 Revenue Act of 1918, § 253.

Attempts to Evade the Tax. Any individual, corporation or partnership wilfully attempting in any manner to defeat or evade the tax is guilty of a misdemeanor and may be fined not more than $10,000, or imprisoned for not more than one year, or both, together with the costs of prosecution.[24]

Failure to Pay Tax. Any individual, corporation or partnership failing wilfully or otherwise to pay the tax at the time or times required is liable to the same specific penalties which attach for failure to make a return accordingly as such failure is or is not wilful.[25] In addition, as set forth in another chapter[26] interest will be added, the tax will become a lien, and the goods, chattels or effects, including stocks, securities and evidences of debt, of the taxpayer will be subject to distraint and sale.

Delay in the Payment of the Tax. As a general rule, if any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector there will be added as part of the tax the sum of 5% on the amount due but unpaid, and interest at the rate of 1% per month upon such amount from the time it became due. This penalty and interest do not accrue in case of any tax due from the estates of insane, deceased or insolvent persons. When an assessment has been made for a tax or penalty and a bona fide claim for abatement is filed, the time ceases to run against the claimant as to the 5% penalty, from the time the tax was due until the claim is decided.[27] Under the 1916 Law upon receipt of the notice of rejection of the claim, the tax might be paid within ten days from the date of the notice without penalty.[27a] Interest at the rate of ½ of 1% per month, however, continues to run from the time the tax was due until the claim is de-

[24] Revenue Act of 1918, § 253.
[25] Revenue Act of 1918, § 253.
[26] See Chapter 35 on Assessment and Payment of the Tax.
[27] Revenue Act of 1918, § 250 (d).
[27a] Reg. No. 14, October 15, 1916; Reg. No. 1, Page 110.

cided, nothwithstanding that a claim for abatement has been filed.[27b]

Penalty for Divulging Information. The penalty in the case of any collector, deputy collector, agent, clerk or other officer or employee of the United States who divulges information in his possession and acquired in the performance of his duties, is treated elsewhere in this book.[28]

Statute of Limitations. The Revised Statutes provide that no suit or prosecution for any penalty or forfeiture, pecuniary or otherwise, accruing under the laws of the United States, shall be maintained, except in cases where it is otherwise specially provided, unless the same is commenced within five years from the time when the penalty or forfeiture accrued. The statute does not run, however, if the person liable for the penalty is not to be found within the United States so that proper process may be instituted and served against him.[29] The period of limitation applies whether the action is *in personam* or *in rem.*[30] The courts have no power to engraft any exception on this statute in cases of concealed fraud which is not discovered until after the expiration of five years.[30a] The States cannot pass any statute of limitations which will bind the Federal Government, or which will furnish the rules for determining whether an action is brought in time, except as Congress has clearly manifested its intention that the United States shall be so bound.[30b]

Compromise of Penalties. The Commissioner, with the advice and consent of the Secretary, may compromise any civil or criminal case arising under the internal revenue

[27b] Revenue Act of 1918, § 250 (d). See Chapter 35 on Assessment and Payment of the Tax.

[28] R. S., § 3167, as amended by Revenue Act of 1918. See Chapter 34 on Returns.

[29] R. S., § 1047.

[30] Hatch v. The Boston, 3 Fed. 807, 810.

[30a] U. S. v. Maillard, 26 Fed. Cas. No. 15,709.

[30b] Arnson v. Murphy, 109 U. S. 238; U. S. v. Nashville Rd. Co., 118 U. S. 125.

laws instead of commencing suit thereon; and, with the advice and consent of the said Secretary, and the recommendation of the Attorney General, he may compromise any case after a suit thereon has been commenced. Whenever a compromise is made in any case the opinion of the Solicitor of Internal Revenue or of the officer acting as such, with his reasons therefor, with a statement of the amount of tax assessed, the amount of additional tax or penalty imposed by law in consequence of the neglect or delinquency of the person against whom the tax is assessed, and the amount actually paid in accordance with the terms of the compromise, must be placed on file in the office of the Commissioner.[31] The Commissioner has under this section no power to compromise a suit against the government,[32] the power being limited to suits which the government may prosecute. A compromise operates for the protection of the offender against subsequent proceedings as fully as a formal conviction or acquittal, and is a bar to further action.[33] Where an action is brought by the United States against a delinquent taxpayer, for having failed to file a return, the verdict must specifically state the amount of the penalty, after which the only remedy of the defendant (other than an appeal) is to apply for a compromise.[34] Offers in compromise should include payments of cost.[35] The amount of the offer should be deposited with the Commissioner, but cannot be held or set off against the tax due.[36] Refunds cannot be made of offers in compromise where it is subsequently ascertained that no violation of law was involved.[36a]

31 R. S., § 3229; See § 3469, as to compromise of cases after judgment.

32 23 Op. Atty. Gen. 507.

33 U. S. v. Chouteau, 102 U. S. 603.

34 U. S. v. Acorn Roofing Co., 204 Fed. 157.

35 T. D. 642, March 20, 1903.

36 Boughton v. U. S., 12 Ct. Cls. 330.

36a Reg. 45, Art. 1011.

Specific Penalties. While the sections of the Revised Statutes relating to compromise[37] do not in express language refer to the compromise of the specific penalty for failure to file the return, neither are they restricted in terms, nor by any reason of public policy, to penalties for the non-payment of taxes. In the opinion of the Attorney General the application of these sections to the compromise of penalties for failure to file returns in time is proper, and, further, in such compromises the Commissioner is authorized to consider not only the pecuniary interests of the Treasury, but also general considerations of justice, equity and public policy.[38]

Twenty-five Per Cent. Increase of Tax. A penalty (50%) corresponding to the penalty of 25% increase in tax for failure to file returns is found in practically all revenue laws relating to special taxes, and the uniform construction has been that no administrative officer is clothed with authority to compromise such increase in tax.[39] The income tax law is explicit and mandatory in its provisions relative to the additional assessment of 25% of the tax otherwise due, in case of failure to file a return of income within the prescribed time except when a return is filed after such time and it is shown that the failure was due to reasonable cause and not to wilful neglect, and does not give discretionary authority for remission of these additional taxes to any officer of the government.[40] Since the corresponding 50% penalty was not subject to compromise under the general revenue laws, Congress passed an act providing particularly for the refund of such additional taxes, assessed under the 1909 Law, for neglect to file returns,[41] but no such statute has been passed with respect to penalties incurred under the 1913, 1916, or 1918 laws.

[37] R. S., §§ 3229 and 3469.
[38] 29 Op. Atty. Gen. 217.
[39] T. D. 1701.
[40] T. D. 2135.
[41] Act of March 3, 1913.

Offers in Compromise. It has been the practice of the Treasury Department to accept, as a minimum offer, $5 from individuals and withholding agents, and $10 from corporations, in compromise of the specific penalty incurred for failure to file returns, in cases where the neglect was not intentional.[42] Offers in compromise do not receive favorable consideration in cases where returns for the year in question have not been filed, but such offers are accepted "subject to the filing of the return."[43] No particular form is prescribed for use in making offers in compromise of the specific penalties, and such offer may be made in the form of a letter addressed to the local collector. Each offer in compromise should be accompanied by an affidavit in which the proponent should state briefly the facts which caused the delinquency. Where affidavits allege facts that no delinquency was incurred or recite circumstances which warrant relief from the specific penalty, the offer is returned, unless there are facts in the possession of the collector at variance with the contentions made by the proponents. All delinquents who do not compromise their liabilities to the specific penalty, after ample opportunity, are reported to the United States District Attorney for proceedings.[44] It is the duty of every District Attorney to prosecute every case for the collection of a fine, penalty or forfeiture reported to him by any collector, unless, upon inquiry and examination, he decides that such proceedings cannot properly be sustained, or that the needs of public justice do not require that such proceedings be instituted; in which case he reports the facts to the Commissioner for his direction.[45] Under the 1864 Law as amended in 1870 only one penalty was permitted to be recovered for all failures to make a return prior to the commencement of the action for the collection of a penalty.[46]

42 T. D. 2311; T. D. 2349.

43 T. D. 2311.

44 T. D. 2311.

45 R. S., § 838.

46 U. S. v. Brooklyn etc. Ry. Co., 14 Fed. 284; U. S. v. N. Y. Guaranty Co., 8 Ben. 269.

CHAPTER 37

EXAMINATION OF TAXPAYERS' BOOKS

The Revenue Act of 1918 and the Revised Statutes contain certain provisions for the examination of taxpayers' books by revenue agents or inspectors, the attendance of witnesses before the Commissioner and the production of books in suits or proceedings arising under the revenue laws which are set forth in the following paragraphs.

Examination of Books. For the purpose of ascertaining the correctness of any return or making a return where none has been made, the Commissioner may, by any revenue agent or inspector designated by him for that purpose, examine any books, papers, records or memoranda bearing upon the matters required to be included in the return.[1]

Requiring Attendance of Witnesses. For the purpose stated in the previous paragraph the Commissioner of Internal Revenue may require the attendance of the person rendering a return or of any officer or employee of such person *or the attendance of any other person having knowledge in the premises*[2] and may take his testimony with

[1] Revenue Act of 1918, § 1305. In relation to the income tax this provision seems to supplant R. S., § 3173, which as amended, omits the second case "in case of income tax on or before the first day of March in each year, or on or before the last day of the sixty day period next following the closing date of the fiscal year for which it makes a return of its income" and also omits the phrase "amount of annual income charged with a duty or tax."

[2] The italicized words would seem to have been inserted to avoid the effect of such decisions as In re Chadwick, 5 Fed. Cas. No. 2,570, 11 Int. Rev. Rec. 126, 133, which held under a similar statute that the books which the assessor has the right to examine are those of the person whose assessment is in question and not those of

reference to the matters required to be included in such return. The Commissioner, every collector, deputy collector, Internal Revenue agent, and Internal Revenue officer assigned to duty under an Internal Revenue agent is clothed with power to administer oaths to such person or persons as may be required to attend any hearing before him.[3]

Requiring Production of Books. In all suits and proceedings, other than criminal,[4] arising under any of the revenue laws of the United States, the attorney representing the Government may, whenever in his belief any business-book, invoice or paper, belonging to or under the control of the defendant or claimant, will tend to prove any allegation made by the United States, make a written motion particularly describing such book, invoice or paper, and setting forth the allegation which he expects to prove: and thereupon the court may, at its discretion, issue a notice to the defendant or claimant to produce the same. Upon failure to do so the allegation stated in the motion is taken as confessed, unless the failure or refusal is explained to the satisfaction of the court.[5] This provision applies to proceedings under the Internal Revenue laws as well as the customs revenue laws.[6]

Enforcement of Provisions Requiring Examination, Attendance and Production. If any person is summoned to appear, to testify, or to produce books, papers or other data, the United States District Court for the district in which such person resides is invested with jurisdiction of appropriate means to compel such attendance, testimony, or pro-

third persons who have had dealings with him, and consequently that a corporation was not bound to produce its books upon an inquiry into the income of its shareholders.

[3] Revenue Act of 1918, § 1305; R. S., § 3165, as amended.

[4] In Boyd v. U. S., 116 U. S. 616, it was held that proceedings to forfeit a person's goods for an offense against the law, though civil in form, and whether *in rem* or *in personam*, was a "criminal" case, within the meaning of this provision of law.

[5] Act of June 22, 1874, 18 Stat. 187.

[6] U. S. v. Distillery No. 28. 25 Fed. Cas. No. 14,966.

duction of books, papers or other data, and to make and issue, both in actions at law and suits in equity, such writs, orders, judgments, decrees and process as may be necessary or appropriate for the enforcement of any provisions requiring such attendance, testimony or production, but only at the instance of the United States. Any remedy of application to the District Court is in addition to and not exclusive of any and all remedies of the United States in such courts and otherwise to enforce such provisions.[6a]

Constitutionality of Statute Providing for Examination and Production of Books. It has been held that (1) the above mentioned provision of law requiring the production of books is unconstitutional and void as to suits for penalties or to establish a forfeiture, because repugnant to the Fourth and Fifth amendments to the Constitution, which are to be construed in relation to each other; (2) actual entry upon premises and search for and seizure of papers is not required to bring a case within the meaning of the Fourth amendment prohibiting unreasonable searches and seizures; (3) a compulsory production of a party's private books and papers to be used against him or his property in a criminal or penal proceeding or proceeding for a forfeiture is within the spirit of such amendment; (4) it is equivalent to compulsory production to make non-production a confession of the allegations which it is pretended such books will prove; (5) a proceeding to forfeit goods, though civil in form and whether *in rem* or *in personam*, is a criminal case within the meaning of the Fifth Amendment which declares that no man "shall be compelled in any criminal case to be a witness against himself;" and (6) the seizure or compulsory production of a man's private papers to be used against him is equivalent to compelling him to be a witness against himself.[7] It is doubtful, however, whether this decision and others of a similar purport [8]

[6a] Revenue Act of 1918, § 1318.

[7] Boyd v. U. S., 116 U. S. 616.

[8] Weeks v. U. S., 232 U. S. 383; In re Pacific Railway Comm., 32 Fed. 241.

relate to proceedings to assess and recover unpaid taxes, or to discover the extent of a person's tax liability, to accomplish which ends the compulsory production of books and papers may be considered a legitimate and appropriate means within the legislative discretion. The constitutionality of a similar statute for the enforcement of the Internal Revenue laws has been upheld,[9] and it has been asserted that acts conferring the high power upon administrative officers of compelling the production of books and attendance of persons have been acquiesced in for so long a time without serious objection that their constitutionality is no longer open to debate.[10] Upon a *habeas corpus* proceeding in the case of a tobacco manufacturer who was committed for failure to appear and produce books in obedience to a summons, it was held that (1) he must bring the books containing the entries relating to his business before the assessor; and (2) he might then be asked to exhibit any entry relating to a particular point and if he should say he could not do so without incriminating himself, he would be protected from exhibiting it.[11] In a later case[12] in the Supreme Court, which sustained the validity of the Interstate Commerce Act so far as it gave power to the Commission to require the attendance of wit-

9 In re Strouse, 23 Fed. Cas. No. 13,548; 1 Sawy. 605; 11 Int. Rev. Rec. 182.

10 Perry v. Newsome, 19 Fed. Cas. No. 11,009; 10 Int. Rev. Rec. 20.

11 In re Lippman, 3 Ben. 95; 15 Fed. Cas. No. 8,382; 9 Int. Rev. Rec. 1. This case arose under section 14 of the act of June 30, 1864.

12 Interstate Commerce Commission v. Brimson, 154 U. S. 447; 155 U. S. 3. This argument is disposed of in another manner in Re Phillips, 19 Fed. Cas. No. 11,097; 10 Int. Rev. Rec. 107. The court makes the following quotation from Peo. v. Hackley, 24 N. Y. 83: "But neither the law nor the constitution is so sedulous to screen the guilty as the argument supposes. If a man cannot give evidence upon the trial of another person without disclosing circumstances which will make his own guilt apparent, or at least capable of proof, though his account of the transaction should never be used as evidence, it is the misfortune of his condition and not any want of humanity in the law."

nesses and the production of papers, it was held that it was open to each witness to contend that he was protected by the Constitution from answering the questions propounded to him, that he was not legally bound to produce the books or papers and that neither the questions propounded nor the books called for related to the matter under investigation. This authority by analogy would seem to dispose of the argument that information brought out in a proceeding under the Internal Revenue laws to ascertain the amount of tax liability of any taxpayer might be used against him in a later criminal proceeding or proceeding for a penalty or forfeiture. While a witness being examined *de bene esse* under section 863 of the Revised Statutes may be compelled to produce books and papers which would be material evidence for the party calling him upon the trial of the case, he may not be compelled to produce his books and papers merely for the purpose of refreshing his memory.[13] The cases upon this point are in some confusion and the distinction between criminal or quasi criminal proceedings involving penalties and forfeitures and proceedings to ascertain and recover the amount of any tax due, is nowhere clearly drawn.

Corporations. It will be noted that in so far as the above mentioned provisions relating to the examination of witnesses and the production of books and papers have been or may still be declared void, their unconstitutionality is based upon a violation of the Fourth and Fifth amendments to the Constitution of the United States. It is by no means definitely settled to what extent corporations, which are creatures of the state, are protected and given immunity by virtue of such amendments. In a comparatively recent case in the Supreme Court [14] in was held that corporations

[13] U. S. v. Tilden, 28 Fed. Cas. No. 16,522; 10 Ben. 566; 25 Int. Rev. Rec. 352.

[14] Hale v. Henkel, 201 U. S. 43; Nelson v. U. S.; 201 U. S. 92. The court was considerably divided in this case. The opinion of the majority was delivered by Mr. Justice Brown. Mr. Justice Harlan delivered a separate concurring opinion in which he went

were not protected by the Fifth amendment and that while an individual may lawfully refuse to answer incriminating questions unless protected by an immunity statute, it does not follow that a corporation vested with special privileges and franchises may refuse to produce its books and papers, but the court expressly stated that it did not wish to be understood as holding that a corporation is not entitled to immunity under the Fourth amendment against unreasonable searches and seizures.

National Banks. The law under which national banks are incorporated, which provides for the occasional examination of their affairs and reports of their condition to the national government and enacts that they shall not be subject to any visitorial powers other than are authorized by the act or are vested in the courts of justice, does not exempt them from liability to examination.[15]

Examination of Books and Papers in the Cases of Special Taxes and Other Cases. In the case of any special tax and in the case of other[16] taxes it is the duty of any person, partnership, firm, association or corporation liable to make a verified return to the collector where the articles

further than the majority and stated his opinion that a corporation could not claim immunity under the Fourth amendment for the reason that it is not a part of the "people" or embraced by the word "persons" as used in that amendment. Mr. Justice McKenna, also concurring, stated his opinion that corporations had no immunity under the Fourth amendment, because as stated in Boyd v. U. S., 116 U. S. 616, the Fourth and Fifth amendments were complimentary of each other and the denial of the protection of one carried a denial of the protection of the other. Mr. Justice Brewer, with whom the Chief Justice concurred, dissented, and stated their opinion that the immunities and protection of the Fourth and Fifth amendments are available to corporations so far as in the nature of things they are applicable. In International Mining Co. v. Pennsylvania Railroad Co., 152 Fed. 557, Judge Holland, in holding that a corporation may not refuse to produce its books in an action against it to recover damages or penalties for a violation of the Interstate Commerce Commission act, expresses the opinion that the question had been practically disposed of by Hale v. Henkel.

15 U. S. v. Rhawn, 27 Fed. Cas. No. 16,150.

16 See Note 1.

or objects or goods, wares or merchandise charged with the tax are located. In case of failure to make such return if the person liable consents to disclose the particulars, it is the duty of the collector or deputy collector to make the list or return which, when consented to, is received as the return of such person. If any person, on being notified or required to make this return by the leaving at his place of residence or business with someone of suitable age or discretion or the depositing in the nearest post office a memorandum addressed to him, refuses or neglects to make the return within ten days from the date of the notice, or delivers any return, which in the opinion of the collector is erroneous, false or fraudulent or contains any under-valuation or under-statement, or refuses to allow a regularly authorized government officer to examine his or its books, the collector may summon such person, partnership, firm, association or corporation or any person having possession, custody or care of the books of account containing entries relating to the business of such person, partnership, firm, association or corporation, or any other person, to appear before him and produce the books and give testimony or answer interrogatories respecting any objects liable to tax or the returns thereof. When the person intended to be summoned does not reside in the state or territory in which the collector's district lies, the collector may enter any collection district where the person may be found and there make the above examination.[17]

Instructions to Revenue Agents. The following instructions have been given by the Treasury Department to revenue agents and examiners: "In conducting their examination the agents will, except in clear cases of misrepresentation, proceed on the assumption that all errors in the returns rendered are unintentional; and they will, so far as possible, make their examination in such manner as not to interfere with the company's business, either as to the use of its books or in the general conduct of its

[17] Revised Statutes, § 3173 as amended. See Reg. 33, Art. 186.

affairs. Contentions with officers, employees or representatives of corporations are to be carefully avoided, and no action that may cause friction, that is not necessary in the proper performance of their duties, must be indulged in by officers making these examinations. Ordinarily no very extended examination of the company's books will be necessary, as the verification of the particular items to which attention has been called will be sufficient. Where, however, a thorough examination is found to be necessary, and the accounts are so kept as to involve much labor in their examination, the agent may assign two assistants for this purpose. Where discrepancies between the company's books and the return made are discovered, the officers of the company should be given full opportunity to explain the same, and to furnish, if so desired, a sworn statement in reference thereto. In such cases the agent will, if deemed necessary, require the attendance of any officer or employee of the company, and there examine such officer or employee respecting the matter under investigation. The witnesses in such cases should be duly sworn by the agent, and in case of refusal of any such officer or employee to testify, or in the case of refusal to produce the books or papers called for, the agent will at once report the fact to this office."[18]

[18] T. D. 1617.

CHAPTER 38

ABATEMENT, REFUND AND RECOVERY OF TAXES

The prompt collection of the revenue and its faithful application is one of the most vital duties of government. Depending, as the government does, upon its revenue to meet not only its current expenses, but to pay the interest on its debt, it is of the utmost importance that it should be collected with despatch, and that the officers of the Treasury should be able to make a reliable estimate of means in order to meet liabilities. It would be difficult to do this, if the receipts paid into the Treasury were liable to be taken out of it, on suits for alleged errors and mistakes, concerning which the officers charged with the collection and disbursement of the revenue had received no information. To guard against such consequences, Congress has from time to time passed laws on the subject of the revenue, which not only provide for the manner of its collection, but also point out a way in which errors can be corrected. These laws constitute a system which Congress has provided for the benefit of those persons who complain of illegal assessments of taxes and illegal exactions of duties. The party aggrieved can test the question of the illegality of an assessment or collection of taxes by suit; but he cannot do this until he has taken an appeal to the Commissioner. Thus it will be seen that the person who believes he has suffered wrong at the hands of the collector can appeal to the courts; but he cannot do this until he has taken an intermediate appeal to the Commissioner, and, in any event, he is barred from bringing a suit, unless he does it within the period limited by law. The object of these different provisions is

apparent. While the government is desirous to secure to the citizen a mode of redress against erroneous assessments or collections, it says to him: "We want all controverted questions concerning the revenue settled speedily, and if you have complaint to make, you must let the Commissioner of Internal Revenue know the grounds of it; but if he decides against you, or fails to decide at all, you can test the question in the courts if you bring your suit within a limited period of time."[1] The Commissioner, subject to regulations prescribed by the Secretary, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed, or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected.[2] The Revenue Act of 1918 changes the provision[3] in regard to the refund of taxes paid in excess of the amount properly due. This provision is discussed in a later paragraph in this chapter.

Taxes Paid on Second Assessment. When a second assessment is made in case of a list, statement, or return, which, in the opinion of the collector, or deputy collector, was false or fraudulent, or contained any understatement or undervaluation, such assessment shall not be remitted, nor shall taxes collected under such assessment be refunded, or paid back, or recovered by any suit, unless it is proved that such list, statement, or return, was not willfully false or fraudulent, and did not contain any willful understatement or undervaluation.[4]

[1] U. S. v. Real Estate Savings Bank, 104 U. S. 728. See also Nichols v. U. S., 7 Wall. 122, modified in regard to its holding that cases under the revenue laws were not within the jurisdiction of the Court of Claims in U. S. v. Kaufman, 96 U. S. 567 and U. S. v. Real Estate Saving Bank, 104 U. S. 728.

[2] R. S., § 3220, as amended by the Revenue Act of 1918 by striking out the words "on appeal made to him (Commissioner of Internal Revenue)."

[3] Revenue Act of 1918, § 252.

[4] R. S., § 3225 as amended by the Revenue Act of 1918. This amendment combines the former proviso clause of R. S. § 3220 with

Who May Claim Recovery of Tax. As a general rule, the taxpayer against whom the tax is assessed and by whom the tax is paid is the one who is entitled to claim abatement or refund or sue for its recovery. If the person against whom the tax is assessed is dead, the claim should be made in the name of the executor or administrator.[5] In cases where the tax has been withheld at the source the claim for abatement or refund may be made either by the withholding agent against whom the assessment was made or by the person for whose account such taxes were withheld.[6] Where one corporation had leased all of its property to another, a tax being thereafter assessed upon the lessor, and its claim for an abatement being rejected, the tax was paid by the lessee to avoid the penalty threatened by the collector and to avoid distraint and sale of the leased property. The court held that the payment by the lessee was not voluntary and that it was entitled to sue for its recovery without regard to privity of contract between it and the collector.[7]

Abatement. Under the 1916 Law the Secretary of the Treasury provided two forms for the purpose of refund and abatement. One was made applicable to the return of taxes and penalties illegally, or improperly assessed and paid, and the other to an abatement of their assessment. The former was applicable to cases where the taxes and penalties had been paid, and the latter to cases where they had not been paid. These regulations of the Secretary have the force of law, and the Federal Courts are obliged to take notice of them. Furthermore, they are obviously binding

R. S. § 3225 in its previous form; and also by the insertion of the words "wilful" and "wilfully" is a statutory enactment of the decision in Northwestern Mut. Life Ins. Co. v. Fink, 248 Fed. 568. The Government has withdrawn from the position taken by it in Camp Bird Ltd. v. Howbert, 249 Fed. 27, and the case has been dismissed in the Supreme Court.

5 Reg. 33 Rev., Art. 266. Certified copies of the letters of administration or letters testamentary or other similar evidence should be annexed to the claim in such case.

6 Reg. 33, Art. 33.

7 Cambria Steel Co. v. McCoach, 225 Fed. 278.

upon the Commissioner and he obtains jurisdiction to pass upon a claim only when and as they have been complied with. The merits of a case come before him when a proper claim has been made. Under a claim for abatement he can only determine whether or not the assessment should be abated. Any further action would be in violation of the regulations and beyond his jurisdiction.[8] The Commissioner possesses no equity powers in case of abatement; if the tax is a legal one he cannot abate it.[9] It seems that the Commissioner has no authority to revoke the abatement of a tax once made by him, but he may re-assess the tax.[10]

Effect of Rejection of Claim for Abatement. By weight of authority it seems that, if an appeal is taken from an assessment and decided against the appellant, and the tax is afterwards collected, it is not necessary to take a second appeal for refund of the payment before commencing suit to recover the tax.[11] When the abatement claim has been considered and rejected upon its merits, no claim for refund is necessary to lay foundation for a suit.[12] In a recent case it was said: "What the Commissioner of Internal Revenue thought about the assessment had been obtained upon full statement of the facts, and it would have been a useless form again, after the tax was paid, to appeal to the Commissioner and obtain the same judgment. The reason for the appeal did not exist, and hence the appeal after the tax was paid was not necessary." [13] This seems to be the general rule, but it has also been held to the contrary that under a claim for abatement the Commissioner can only determine whether or not the assessment

8 Hastings v. Herold, 184 Fed. 759. For a full discussion of the force and effect of the departmental rulings and regulations of the Secretary see Chapter 43 on Construction of the Law and Chapter 1.

9 Decision No. 180, 36 Int. Rev. Rec. 13.

10 U. S. v. Alexander, et. al., 110 U. S. 325.

11 San Francisco Savings Society v. Cary, 2 Sawy 393.

12 DeBary v. Dunne, 162 Fed. 961; Schwarzschild & Sulzberger Co. v. Rucker, 143 Fed. 656; T. D. 974; Grier v. Tucker, 150 Fed. 658; T. D. 1293; Contra, Hastings v. Herold, 184 Fed. 759.

13 Weaver v. Ewers, 195 Fed. 247.

should be abated. Any further action would be in violation of the regulations and beyond his jurisdiction, and where the abatement was rejected, but no application was made for refund after paying the tax, it was held that a suit could not be maintained.[14]

PROCEDURE FOR CLAIMING ABATEMENT. Claim for abatement of taxes or penalties erroneously or illegally assessed, or which are abatable under remedial acts, etc., must be made out of the form prescribed by the government [15] and must be sustained by the affidavits of the parties against whom the taxes were assessed, or of other parties cognizant of the facts.[16] The practice is to obtain the official form from the local collector, prepare it according to instructions and file it with the local collector. The claim for abatement can only be made between the time the tax is assessed and the date it is due. If the claim has not been acted upon within ten days after notice and demand for the tax, 5% penalty for failure to pay the tax will not accrue if the tax is paid within ten days after the claim for abatement is rejected, and interest from the time the amount was due until the claim is decided will be at the rate of ½% per month instead of one per cent. The rule waiving penalty and reducing interest obtains only as to any amount of tax which is the subject of a *bona fide* claim for abatement.[17]

Refund. Where the Commissioner, in a case within the scope of his authority and jurisdiction, has ordered a refund, a court cannot inquire as to the sufficiency of the evidence before him,[18] and neither the Comptroller of the Treasury nor any accounting officer has authority to review the Commissioner's decision.[19] Decisions by the Commis-

14 Hastings v. Herold, 184 Fed. 759. The weight of authority seems to be contrary to the rule in this case.

15 The form prescribed prior to the 1918 Law by the Government was known as Form 47.

16 Reg. No. 14 Rev. October 15, 1911, as modified by T. D. 2654.

17 Revenue Act of 1918, § 250 (e).

18 Woolner v. U. S., 13 Ct. Cls. 355.

19 Bank of Greencastle v. U. S., 15 Ct. Cls. 225. In Sybrandt v. U. S., 19 Ct. Cls. 461, it was held that even three adverse decisions

sioner, in cases where a refund is directed, are binding and, in the absence of fraud, or mistake of calculation, not subject to revision.[20] The Commissioner's decision is conclusive as to the questions of fact,[21] but apparently not as to questions of law.[22] His decisions are in the nature of awards made by arbitrators, and generally speaking bind both the claimant and the Government. A refund may be impeached for fraud, want of jurisdiction, mistake apparent in the certificate, or for such irregularities as would avoid an award.[23] The Commissioner may reconsider and revoke an allowance for refund at any time before the allowance is paid, but whether a commissioner has power to revoke an allowance made by his predecessor is not clear.[24] Where one Commissioner recommended the allowance of the claim and referred the matter to the Secretary for advisement, a succeeding Commissioner to whom the matter was referred back could reject the claim.[25] The Commissioner is not precluded from allowing a claim for refund because a former Commissioner rejected a claim for abatement, and he is authorized to reconsider and allow a claim which he had, through error of law, previously rejected. An application for the refund of taxes, though informal or defective, may be regarded as a claim, so far at least as to permit a formal amendment to be filed after the statute of limitations has run.[26] The Commissioner has no authority to remit the 25% penalty unless it is illegally collected. The words "wrongfully collected" are construed as synonymous with the words "illegally collected."

of successive Secretaries would not prevent a Commissioner from taking up and allowing a claim for the refund of taxes.

20 Dugan v. U. S., 34 Ct. Cls. 458.

21 U. S. v. Wright, 11 Wall. 648.

22 Comp. Dec. 259.

23 Dugan v. U. S., 34 Ct. Cls. 458; Cumming v. U. S., 22 Ct. Cls. 344.

24 Ridgway v. U. S., 18 Ct. Cls. 707.

25 Stotesbury v. U. S., 23 Ct. Cls. 285.

26 14 Op. Atty. Gen. 615.

No equity powers are conferred on the Commissioner, and the Commissioner is authorized, not obliged, to refund.[27]

STATUTE OF LIMITATIONS. Except as stated in the next paragraph all claims for refund must be presented to the Commissioner within two years next after the cause of action accrued,[28] that is after the tax was paid. Failure to make a claim for refund within two years after paying the tax is a bar to a suit thereon.[29] Presentation to the collector is equivalent to presentation to the Commissioner.[30] Where a protest was held by the Commissioner to be an informal appeal, and a formal application for refund was thereafter acted upon, although made after the expiration of two years, his decision was held to be conclusive and could not be set aside by the court.[31]

WHEN STATUTE OF LIMITATIONS IS EXTENDED. Although generally the provisions referred to in the previous paragraph [32] limit all claims for refund to a period of two years after the tax has been paid, an extension of this time is granted in cases where, upon examination of any return of income made pursuant to the Revenue Act of 1918, the Revenue Act of 1917, the 1916 Law, the 1913 Law or the 1909 Law, it appears that an amount of income, war-profits or excess-profits tax having been paid in excess of that property due. In such case, notwithstanding the provision of law referred to in the preceding paragraph [33] the amount of excess is credited against any income, war-profits or excess-profits taxes or installment thereof then due under any other return and any balance of such excess is immediately refunded to the taxpayer, provided that no such credit or refund shall be allowed or made after five years

[27] 16 Op. Atty. Gen. 667; 13 Op. Atty. Gen. 439.
[28] R. S., § 3228.
[29] Kings County Savings Institution v. Blair, 116 U. S. 200.
[30] Real Estate Savings Bank v. U. S., 16 Ct. Cls. 335; 104 U. S. 728.
[31] Bank of Greencastle v. U. S., 15 Ct. Cls. 225.
[32] R. S., § 3228.
[33] R. S., § 3228.

from the date when the return was due, unless before the expiration of such five years a claim therefor is filed by the taxpayer.[34] This provision was inserted as a remedy in cases where an agent of the Treasury Department makes an examination of a taxpayer's books within five years [35] after a return has been filed and discovers undisclosed income. An examination may also disclose an overpayment, as well as undisclosed income, in which case the result of the examination may operate to the benefit of the taxpayer as well as to the benefit of the Government, regardless of the statute of limitations. Claims once rejected by the Commissioner, because of the statute of limitations, in existence at that time, may be reopened under this provision, if the adjustment necessitates an examination of the return, but not otherwise.[36]

PROCEDURE. The provisions for claiming refund must be strictly complied with.[37] Claim for the refunding of assessed taxes and penalties must be made out upon the form prescribed by the Government. The burden of proof rests upon the claimant. All the facts relied upon in support of the claim must be clearly set forth, under oath.[38] The practice is to obtain a copy of the form from the local collector, prepare it according to instructions thereon. and file it with the local collector for further action. The collectors of internal revenue and revenue officers are forbidden to prepare affidavits for persons claiming remission of taxes or penalties under the internal revenue law.[39] An

[34] Revenue Act of 1918, § 252. Under the 1916 Law the taxpayer was merely permitted to present a claim for refund, such a claim not being ordinarily necessary under the present law. See Revenue Act of 1916, § 14.

[35] This limitation was three years under the 1916 Law. Revenue Act of 1916, § 14 (a).

[36] T. D. 2396.

[37] Public Service Ry. Co. v. Herold, 219 Fed. 301; Public Service Gas Co. v. Herold, 227 Fed. 496, 229 Fed. 902.

[38] Reg. 14 Rev. The form to be used in claiming refund was officially known under the 1916 Law as Form 46.

[39] T. D. 2443.

appeal for abatement or refund is imperfect if it does not have endorsed thereon the affidavit of the deputy collector and certificate of the collector required by the regulations,[40] but this is a matter of action within the Department.

Suits to Recover Taxes. If a claim is rejected by the Commissioner, a judicial remedy is given the taxpayer by an action against the collector or the United States. If the claim is allowed by the Commissioner and payment refused by the accounting officers, a suit may be brought directly against the Government in the Court of Claims.[41] The allowance of the claim by the Commissioner may be used as the basis of an action against the United States in the Court of Claims, when payment is not made by reason of the refusal of any of the officers of the Department to pass or to pay the claim, and it will be prima facie evidence of the amount that is due, and puts on the Government the burden of showing fraud or mistake.[42] Before a suit can be commenced to recover taxes erroneously or illegally assessed or collected, or upon any penalty claimed to have been collected without authority, or for any sum alleged to have been excessive or in any manner wrongfully collected, an appeal must be made to and a decision rendered by the Commissioner, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof. If such decision is delayed more than six months from the date of appeal, suit may be brought, without first having a decision of the Commissioner,[43] but need not be commenced until within two years after the Commissioner has denied the claim.[44] No suit to recover taxes alleged to have been erroneously or illegally assessed or collected may be maintained in any court, unless it is

[40] Hastings v. Herold, 184 Fed. 759.

[41] Edison Electric Co. v. U. S. 38 Ct. Cls. 208.

[42] U. S. v. Real Estate Savings Bank, 104 U. S. 728; Kaufman v. U. S., 96 U. S. 567; Christie-Street Commission Co. v. U. S., 136 Fed. 326.

[43] R. S., § 3226.

[44] R. S., §§ 3226 and 3227.

brought within two years next after the cause of action accrued.[45] The accrual of the cause of action for purposes of a suit against the government or a collector is the date when the Commissioner decides adversely to the taxpayer; that is, the claimant may await the decision of the Commissioner, and if it is adverse, may bring suit within two years thereafter. But he is not required to await such adverse decision; he may at his election bring suit at any time after the expiration of six months from the filing of his claim for refund, if no decision has been rendered by the Commissioner.[46] For example if a tax is paid on June 28, 1918, the claim for refund must be filed on or before June 28, 1920.[47] If the claim is filed on June 28, 1920, the taxpayer may commence his action on December 29, 1920, if no decision has been rendered by the Commissioner. If, however, an adverse decision is rendered by the Commissioner on September 21, 1920, the taxpayer may at once institute action but has until September 21, 1922, in which to do so. The rejection of a claim, by the Commissioner, must be on the merits and not for irregularity in the form in order to support an action.[48] If an imperfect claim is filed within two years, it seems to be within the statute, although the corrected application is not made within that time, and if suit is brought within two years after rejection of the corrected claim, it is within the statute, although

[45] R. S., § 3227.

[46] New York Mail and Transportation Co. v. Anderson, 234 Fed. 590; State Line & S. R. Co. v. Davis, 228 Fed. 246; Merck v. Treat, 174 Fed. 388; Farrell v. U. S., 167 Fed. 639; Christie Street Commission Co. v. U. S., 136 Fed. 326; Hicks v. James' Administratrix, 48 Fed. 542, affirmed 110 U. S. 272; Cheatham v. U. S. 92 U. S. 85; Kings Co. Inst. v. Blair, 116 U. S. 200. It has been held that the cause of action for purposes of an action against the collector accrued six months after claimant has filed a claim for refund and that the claimant had two years *from that date* within which to bring suit. (Schwarzchild & Sulzberger Co. v. Rucker, 143 Fed. 656).

[47] New York Mail and Transportation Co. v. Anderson, 234 Fed. 590.

[48] Hicks v. James' Administratrix, 48 Fed. 542, affirmed 110 U. S. 272.

more than two years have expired since the first rejection. If the application for refund was filed more than two years after paying the tax, suit cannot be maintained, and the fact that the Commissioner rendered an adverse decision on the application, when filed, does not operate to extend the time.[49]

SUIT AGAINST COLLECTORS. The collector who exacted the tax may be sued for the recovery thereof, but an action thereon cannot be commenced against his successor in office. The remedy lies in an action against the collector to whom the tax was paid, or in an action against the United States.[50] It has been held that an action of *assumpsit* may be maintained against the collector who actually exacted the tax, and such action can be revived against the personal representative of the deceased collector.[51] When once an action has been lawfully commenced against a collector, it does not abate by reason of the expiration of his term, but in such event the court may, under the express provisions of a statute,[52] allow the suit to be maintained against his successor.

SUITS AGAINST THE UNITED STATES. Suit for recovery of taxes alleged to have been wrongfully assessed and collected may be maintained directly against the United States under the so-called Tucker Act.[53] In answer to the question, "Can the plaintiff bring suit to recover taxes, alleged to have been wrongfully assessed and collected under the corporation tax law, directly against the United States under the Tucker Act, other requirements of law having

49 P. S. Ry. Co. v. Herold, 219 Fed. 301.

50 Philadelphia H. and P. R. Co. v. Lederer, 242 Fed. 492. Roberts v. Lowe, 236 Fed. 604. In this case the court said the latter remedy was apparently authorized by the case of U. S. v. Emery, 237 U. S. 28. As to suing collector personally under a state law for damages in wrongfully collecting taxes, see P. S. Ry. Co. v. Herold, 229 Fed. 902, 910.

51 Patton v. Brady, Executrix, 184 U. S. 608.

52 Act of February 8, 1899; 30 Stat. L. 822, c. 121.

53 Judicial Code § 24, ¶ 20; Ch. 397, 24 Stat. 635 (U. S. Compiled Stats. p. 3635).

been complied with, or is its remedy against the Collector of Internal Revenue by whom the assessment and collection were made" it was held that the question was no longer open.[54] The Tucker Act refers to original suits. and does not permit a recovery of demands against the United States on counterclaims.[55]

PROTEST AND DURESS. In order to maintain an action for the recovery of taxes it is necessary that the tax shall have been paid under protest and duress.[56]

Recovery of Interest. It is a well-settled principle that the United States are not liable to pay interest on claims against them, in the absence of express statutory provision to that effect. It has been established as a general rule in the practice of the Government that interest is not allowed on claims against it, whether such claims originate in contract or in tort; whether they arise in the ordinary business of administration, or the private acts of relief by Congress on special application. The only recognized exceptions are where the Government stipulates to pay interest, and where interest is given expressly by an Act of Congress, either by the name of interest, or by that of damages. Not only is this the general principle and settled rule of the executive department of the Government, but it has been the rule of the Legislative Department, because Congress, though well knowing the rule observed at the Treasury, and frequently invited to change it, has refused to pass any general law for the allowance and payment of interest on claims against the Government.[57] Where a person accepts from the Government without objection a refund of a sum illegally exacted he gives up his right to sue for interest.[58] The ground for

[54] Emery, Bird Thayer Realty Co. v. U. S., 198 Fed. 242, citing Christie-Street Commission Co. v. U. S., 136 Fed. 326.

[55] U. S. v. Nipissing Mines Co., 206 Fed. 431.

[56] For a discussion of this subject see Chapter 38 on Assessment and Payment of the Tax.

[57] U. S. v. Bayard, 127 U. S. 251.

[58] Stewart v. Barnes, 153 U. S. 456.

refusal to allow interest is the presumption that the Government is always ready and willing to pay its ordinary debts. When, however, an illegal tax has been collected, the citizen who has paid it, and has been obliged to bring suit *against the collector*, is entitled to interest in the event of recovery from the date of the illegal exaction.[59] In a case where there had been a delay of thirty years in prosecuting a claim to recover internal revenue taxes, interest was not allowed from the date of payment of the taxes, but was allowed from the time of commencing the suit.[60] It seems clear that in a suit against a Collector of Internal Revenue interest may be recovered whether or not the same rule applies to suits against the United States.[61] On recovery of a judgment against a Collector of Internal Revenue for the amount of an internal revenue tax illegally collected, the plaintiff is entitled to have the judgment state that it is with interest.[62] Where judgment is recovered in an action against a collector, interest may be recovered up to the time final judgment is entered and a certificate from the trial court that there was probable cause for the collection of the tax has been given. Upon giving such certificate the claim becomes one against the United States, stopping the right to further interest, unless a review of the judgment by an appellate court is obtained, in which event the judgment upon the mandate of the appellate court will be treated as a final judgment, to the rendition of which interest will be allowed, unless the plaintiff unduly delays the presentation of his claim.[63] A suit against a collector is a private suit and there is no claim against the Government until a certificate of probable cause, under the Revised Statutes,[64] has been obtained

59 Erskine v. Van Arsdale, 15 Wall. 75.
60 Burrough v. Abel, 105 Fed. 366.
61 Conant v. Kinney, 162 Fed. 581.
62 New York Mail and Newspaper Transportation Co. v. Anderson, 234 Fed. 590.
63 Klock Produce Co. v. Hartson, 212 Fed. 758.
64 R. S., § 989.

from the court, at which time the Government assumes a definite liability of the collector, which does not include the payment of interest thereafter; neither is there any further personal liability on the part of the collector. The interest which may be recovered is that put into the judgment before there is any certificate of probable cause, and if none has been put in, the Government assumes no part of the liability of the defendant. The liability assumed by the Government includes interest and costs forming part of the recovery, but does not include interest after judgment.[65]

Costs. The Revised Statutes [66] authorize the Commissioner to repay to any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal revenue taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any assessor, assistant assessor, collector, deputy collector, agent or inspector in any suit brought against him by reason of anything done in the due performance of his official duty. Under this section costs may be recovered against the collector.[67] Judgment is usually given in the District Court for costs and interest.

65 White v. Arthur, 10 Fed. 80.

66 R. S., § 3220, as amended by the Revenue Act of 1918. The amendment extends the provision to assessors, assistant assessors and agents.

67 De Bary v. Carter, 102 Fed. 130. However, see Treat v. Farmers Loan and Trust Co., 185 Fed. 760, 763, as to costs in the Supreme Court and Circuit Court of Appeals.

CHAPTER 39

INFORMATION AT THE SOURCE

To assist in the administration of the Income Tax Law, certain information is required to be furnished by brokers as to their customers, by corporations as to dividend and interest payments, by first or last banks or collection agencies as to foreign items, and by individuals, partnerships and corporations generally (including lessees or mortgagors of real or personal property, fiduciaries, and employers) as to payments of income to others, in order that the Treasury Department may have data on which to audit returns of annual income.[1] The several classes of payments which are required to be reported, and the provisions with respect to each, are discussed in the following paragraphs.

Miscellaneous Income, Gains and Profits. It is provided that payments of interest, rent, salaries, wages, premiums, annuities, compensations, renumerations, emoluments or other fixed or determinable gains, profits and income of $1,000 or more (or any valuable gain) must be reported.[2] "Fixed or determinable gains, profits and income," as used in the law,[3] would seem to include payments of all the kinds expressly enumerated and all payments of a similar nature. In the case of collection at the source payments must be annual or periodical, while in the case of information at

[1] Revenue Act of 1918, §§ 254, 255, and 256. These administrative provisions first appeared in the 1916 Law by amendment in 1917.

[2] Revenue Act of 1918, § 256. There must be payment. Interest accrued on bank deposits before it has passed to the credit of the depositor need not be reported. T. D. 2670.

[3] Id.

the source the law does not contain such a limitation. Hence any payments of the kind described in the law, whether made in isolated cases, or from time to time, must be reported.[4] If the aggregate of several payments made to the same payee equals or exceeds $1,000 in any taxable year, the gross amount should be reported. The payments may be from different forms of income, as for instance, from interest and rent, or interest and salary. In such cases, it seems the total is required by law to be reported, if the aggregate of all payments in the year to the same payee equals or exceeds $1,000.

Salaries, Wages or Compensation. The names of all employees to whom payments exceeding $1,000 a year are made, whether such total sum is made up of wages, salaries, commissions or compensation in any other form, must be reported. Heads of branch offices and subcontractors employing labor, who keep the only complete record of payments therefor, should file returns of information in regard to such payments directly with the Commissioner. When both main office and branch office have adequate records, the return should be filed by the main office. In the case of an employer having a large number of employees who are moved from place to place as the exigencies of the service require, and who consequently has no complete record of annual payments to them at any one place, the salary of two representative months may be taken to establish a fair monthly wage, and unless the yearly payment based on this estimate in the case of an employee amounts to $1,000 or more, no return of payments to such employee is required. When living quarters such as camps are furnished for the convenience of the employer, the ratable cost need not be added to the cash compensation of the employee in determining whether it equals $1,000 annually. But where a person receives as compensation for services rendered a salary and in addition thereto living quarters, the value to

[4] Payments made to corporations, associations, and insurance companies for the year 1917 did not require reporting.

such person of the quarters furnished constitutes income subject to tax, and a return of information is required in such case where the cash compensation received plus the value of living quarters furnished equals $1,000 for the year.[5] Bills paid to employees for board and lodging while traveling under orders or when the employee is employed on a salary basis, are not part of the employee's salary.[6] Commissions paid to soliciting agents for personal services in securing insurance contracts must be reported at the source, but if the agent conducts a branch office or is employed by the company under a contract that makes it necessary to bear the expenses of the branch office and all payments received are intended to cover such expenses; they need not be reported.[7]

PAYMENTS WHICH NEED NOT BE REPORTED. Payments of the following character, although over $1,000, need not be reported in returns of information on Form 1099 (revised): (a) payments of interest on obligations of the United States; (b) dividends paid by domestic or resident corporations; (c) payments by a broker to his customers; (d) payments made to corporations; (e) bills paid for merchandise, telegrams, telephone, freight, storage and similar charges; (f) payments to employees for board and lodging while traveling in the course of their employment; (g) annuities representing the return of capital; (h) payments of rent made to real estate agents (but the agent must report payments to the landlord if they amount to $1,000 or more annually); (i) payments made by branches of business houses located in foreign countries to alien employees serving in foreign countries: and (j) payments made by

[5] Reg. 45, Art. 1072; T. D. 2670; Reg. 33 Rev., Art. 34; Letter from Treasury Department, dated October 25, 1917; I. T. S., 1918, § 1015.

[6] T. D. 2670.

[7] Letter from Treasury Department dated March 28, 1918; I. T. S., 1918, § 3231. See also T. D. 2670 and Letter from Treasury Department dated March 27, 1918; I. T. S. 1918, § 3236.

the United States Government to sailors and soldiers not in excess of $3,500.[8]

Gains and Losses of Customers of Brokers. Every individual partnership or corporation, doing business as a broker must, when directed either specially or by general regulation by the Commissioner, disclose to the Commissioner the names and addresses of customers for whom such broker has transacted any business, with such details as to the profits, losses, or other information which the Commissioner may require, as to each of such customers.[9]

Dividends on Stock of Taxable Corporations. When directed by the Commissioner, either specially or by general regulation, every domestic or resident corporation and every personal service corporation is required to render a return of its payments of dividends, and distributions to stockholders for such period as may be specified, stating the name and address of each stockholder, the number and class of shares owned by him, the date and amount of each dividend paid him, and when the surplus out of which it was paid was accumulated.[10] It will be noted that foreign corporations are subject to this duty if they are resident within the meaning of that térm, as discussed in another chapter.[11]

8 Reg. 45, Art. 1073.

9 Revenue Act of 1918, § 255; Reg. 45, Art. 1061; Reg. 33 Rev., Art. 33. The new law omits the clause of the old defining brokers, "on any exchange or board of trade or other similar place of business." It will be noted that under this provision the Commissioner is given discretion to require or not to require such returns. Form No. 1100 is to be used in making such returns.

10 Revenue Act of 1918, § 254; Reg. 45, Art. 1051. This section omits the catch-all phrase in modification of payments of dividends—"Whether made in cash, or its equivalent, or in stock." See, however, the definition of the term "dividend" in Revenue Act of 1918, § 200. It will be noted that under this provision the Commissioner is given discretion to require or not to require such returns. Form No. 1097 is to be used in making such returns.

11 See Chapter 14. See also Telegram from Treasury Department dated October 14, 1918, I. T. S. 1918, § 3642.

Interest on Obligations of Domestic Corporations. In the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of domestic or resident corporations, the name of the payee is to be reported regardless of the amount of interest paid.[12]

Interest on Obligations of the United States. The law expressly provides that no information at the source is required in the case of payments of interest on obligations of the United States.[13]

State and Municipal Bonds. Although interest received from state and municipal bonds is not subject to tax, the law does not expressly exempt such payments from its requirements as to information at the source; neither does it expressly include such payments. No express provision has been made by ruling or regulation as to the procedure to be followed in this respect.

Foreign Items. The following regulations have been issued under the 1918 Law in regard to foreign items. The rulings under the 1916 Law are indicated in the footnote below.[14]

SOURCE OF INFORMATION AS TO FOREIGN ITEMS. The term "foreign item," as here used, means any dividend upon the stock of a non-resident foreign corporation or any item of interest upon the bonds of foreign countries or non-resident foreign corporations, whether or not such dividend or interest is paid in the United States or by check drawn on a domestic bank. Wherever a foreign country or non-resident foreign corporation issuing bonds has appointed a paying agent in this country, charged with the duty of paying the interest upon such bonds, such paying agent shall be the source of information. If such foreign country or foreign corporation has no such agent, then the last bank or collecting agent in this country shall be the source of information. In the case of dividends on the stock of a non-resident foreign corporation, however, the first bank or collecting

12 Revenue Act of 1918, § 256.

13 Revenue Act of 1918, § 256; Reg. 33 Rev., Art. 37.

14 T. D. 2759, amending Reg. 33 Rev., Art. 35 and T. D. 2716.

agent accepting such item for collection shall be the source of information.[15]

Ownership Certificates for Foreign Items. Where bonds of foreign countries, or bonds or stocks of non-resident foreign corporations, are owned by citizens or residents of the United States, individual or fiduciary, or by domestic or resident corporations or partnerships, or by non-resident alien individuals, corporations or partnerships, ownership certificate Form 1001A (revised) must be executed by the actual owner or his agent when presenting the item for collection, whether such item is a dividend or an interest payment, except in the case of a foreign country or a foreign corporation having a paying agent in this country and issuing bonds which contain a tax-free covenant clause. In such a case the paying agent is required to withhold the normal tax upon the interest on such bonds, and ownership certificate Form 1000 (revised) should be used unless the owner (if so entitled) desires to claim exemption, in which case Form 1001A (revised) should be filed.[16]

Return of Information as to Foreign Items. In the case of collections of foreign items, regardless of amount, the original ownership certificates, when duly filed, shall constitute and be treated as returns of information. In the case of dividends, as to which the first bank or collecting agent is the source of information, it shall detach the ownership certificate and indorse on the item the words, "Certificate detached and information furnished," adding its name and address. When foreign items have been indorsed as above prescribed, the certificates shall be forwarded to the Commissioner (Sorting Division) on or before the 20th day of the month following that during which the items were accepted, accompanied by a letter of transmittal showing the number of certificates and the aggregate amount of foreign items disclosed thereon. In the case of interest items, as to which the paying agent or the last bank or col-

[15] Reg. 45, Art. 1066.
[16] Reg. 45, Art. 1077.

lecting agent in this country is the source of information, the ownership certificate shall accompany the coupon to such agent or source of information, who shall forward the ownership certificate to the Commissioner as above provided with respect to dividend items. Where ownership certificate Form 1000 (revised) is used, a monthly return shall be made on Form 1012 (revised) and an annual return on Form 1013 (revised). The use of substitute certificates is not permitted in the collection of foreign items.[17]

LICENSE. The law provides that all individuals, corporations, or partnerships, "undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks or bills of exchange shall obtain a license from the Commissioner, and shall be subject to such regulations enabling the Government to obtain the information required (under this title), as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both."[18] Application for a license for the collection of foreign items should be made to the collector of the district in which the business is to be carried on. Upon the acceptance of such application the collector will issue to the applicant, without cost, a license which will continue in force until revoked or cancelled.[19] Where the collector is not sufficiently informed as to the entire responsibility of the applicant, or where in any case he deems it advisable, the Commissioner of Internal Revenue, may, upon recommendation of the Collector, require of the applicant a bond in duplicate with satisfactory sureties in a penal sum at least equal to the estimated amount of tax to

17 Reg. 45, Art. 1078.

18 Revenue Act of 1918, § 259.

19 T. D. 2759. Application for such license is made on Form No. 1017.

be withheld by such applicant during any one year; such bond, however, may not be less than $1,000 nor more than $100,000.[20] This bond, if required must be renewed annually before January 1 of each year.[21]

Procedure in Paying Income. In order that the payor of the income required by the law to be reported may obtain the necessary information, the law expressly provides, except in the case of reports of dividend payments and reports by brokers, that the name and address of the recipient of income shall be furnished upon demand to the individual, corporation, or partnership paying the income.[22] All payors of income should obtain in some form the name and address of the recipient of such payments. When the person receiving a payment falling within the provisions of law for information at the source is not the actual owner of the income received, the name and address of the actual owner must be furnished upon demand of the individual, corporation, or partnership paying the income, and in default of a compliance with such demand the payee becomes liable to a penalty of not more than $1,000, unless the failure to comply is wilful, in which event the payee will be guilty of a misdemeanor and will be fined not more than $10,000, or imprisoned for not longer than one year, or both, together with the costs of prosecution.[23] The law imposes no duty, however, upon the payor of the income to inquire upon his own initiative as to the ownership thereof, and it would seem that such payor is fully protected by reporting in good faith the name and address of the one to whom the income is paid.

Returns of Information at the Source. Returns of information at the source must be made as indicated in the following paragraphs.

[20] Reg. 33, Art. 56, January 5, 1914.

[21] T. D. 1909.

[22] Revenue Act of 1918, § 256.

[23] Reg. 45, Art. 1079; Reg. 33 Rev., Art. 36. See also Revenue Act of 1918, § 253.

MISCELLANEOUS INCOME, GAINS AND PROFITS. All persons, including disbursing officers and employees of the United States and fiduciaries, making payment to another person of fixed or determinable income of $1,000 or more in a taxable year must render a return thereof to the Commissioner (Sorting Division) for the preceding calendar year on or before March 15 of each year. The return shall be made in each case on Form 1099 (revised), accompanied by a letter of transmittal on Form 1096 (revised) showing the number of returns filed and the aggregate amount represented by the payments. The street and number where the recipient of the payment lives and whether he is single, married or head of a family should be stated, if possible. Where no present address is available, the last known post-office address must be given.[24]

GAINS AND LOSSES OF CUSTOMERS OF BROKERS. The law provides that the return to be made by brokers, if required by the Commissioner shall state the names of customers (and impliedly their addresses) for whom such broker has transacted any business, with such details as to profits, losses, or other information as the Commissioner may require as to each of such customers.[25] It is ruled that the addresses of customers must be stated in such returns.[26]

[24] Rev. Act of 1918, § 256; Reg. 45, Art. 1071. In the case of payments to nonresident alien individuals or to foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, the returns by withholding agents on forms 1098 (revised) and 1042 (revised) shall constitute and be treated as returns of information. (Reg. 45, Art. 1075.)

[25] Revenue Act of 1918, § 255. Two forms of return are contemplated for the reporting by brokers of the gains and losses of their customers. One form (Form 1100, never issued) shows the total gains and losses of each customer. The other (Form 1096) is merely a letter of transmittal under oath, to be used in forwarding the several forms 1100 to the Commissioner.

[26] Reg. 45, Art. 1061.

Dividends on Stock of Taxable Corporations. With respect to dividend payments of corporations, the law provides that the return to be made by the corporation if required by the Commissioner, shall state the names and addresses of the stockholders, the number of shares owned by each, and the amount of dividends paid to each during the period covered by the report.[27]

Interest on Obligations of Domestic or Resident Corporations. In the case of payments of interest, regardless of amount, upon bonds and similar obligations of domestic or resident corporations, the original ownership certificates, when duly filed, constitute and are treated as returns of information. If a bondholder files no ownership certificate in the case of payments of interest on registered bonds, the withholding agent is required to make out such a certificate in each instance and file it with his monthly return.[28]

Exempt Corporations. Exempt corporations are required to furnish information at the source in the same manner and according to the same rules as other taxable corporations.[29]

27 Revenue Act of 1918, § 254. Two forms of return are contemplated for the reporting of dividends paid by taxable corporations. Form 1097 (revised) gives the required information separately with regard to each stockholder, and must, if required, be forwarded to the Commissioner within ten days from the receipt of notice demanding it. Form 1096 (revised) is merely a letter of transmittal under oath, to be used in forwarding the several forms 1097 to the Commissioner. Reporting at the source by corporations may be required specially or by general regulation (Reg. 45, Art. 1051).

28 Reg. 45, Art. 1074. Monthly return is made on Form No. 1012 (revised). See also Reg. 33 Rev., Art. 43; T. D. 2769.

29 T. D. 2693.

CHAPTER 40

COLLECTION OF TAX AT THE SOURCE

The 1913 Law provided for withholding at the source of the normal tax (1%) on all payments of fixed and determinable income to individuals, whether citizens, residents or non-resident aliens. The 1916 Law provided also for withholding at the source of the normal tax (2%) on payments of similar income to individuals but by the Amendment of October 3, 1917, the law was changed so as to require withholding only (a) on payments of fixed and determinable income (except dividends) to non-resident aliens at the rate of 2%; (b) on payments of interest upon bonds of domestic or other resident corporations to foreign corporations not engaged in trade or business in the United States and not having an office or place of business therein, at the rate of 6%; (c) on payments of dividends of domestic or other resident corporations to foreign corporations not engaged in business in the United States and not having an office or place of business therein, at the rate of 2%; (d) at the rate of 2% on payment of interest on bonds of corporations to individuals, citizens, residents or aliens, if such bonds, or the mortgages under which they were issued, contained a covenant to pay any portion of the income tax for the bondholder, or to pay the interest without deduction for any tax which the corporation might be required or permitted to pay thereon or to retain therefrom under any law of the United States, and (e) at the rate of 6% where the owner of the bond was not known. The amendment was retroactive to January 1, 1917, and any normal tax withheld from income paid to citizens or residents in 1917, other

than interest described in (d) above, was required by the law to be released and paid over to the persons from whose income such tax was withheld.[1]

The 1918 Law provides for withholding at the source on payments of fixed or determinable annual or periodical gains, profits, and income, of any non-resident alien individual (other than income received as dividends from a corporation which is taxable upon its net income) at the rate of 8%, except if the income is from bonds, mortgages, or deeds of trust or similar obligations of a corporation containing a covenant to pay the tax for the bondholder, in which case withholding shall be at the rate of 2%.[2] It is also provided that payments of fixed or determinable annual or periodical gains, profits, and income, of any foreign corporation not engaged in business within the United States and not having an office or place of business therein (other than income received as dividends from a corporation which is taxable upon its net income) shall be withheld at the rate of 10% except in cases where the income is from bonds, mortgages, or deeds of trust or other similar obligations of a corporation containing a covenant to pay the tax for the bondholder, in which case withholding shall be at the rate of 2%.[3] No withholding is required on payment of fixed or determinable income to partnerships whether resident or non-resident, or to citizens or residents, except in any case where bonds, mortgages, or deeds of trust or other similar obligations of a corporation contain a covenent to pay the tax, in which case withholding is required at the rate of 2%.[4] In no case is any tax withheld at the source on payments to domestic corporations or to foreign corporations having an office or place of business in the United States.

Fixed or Determinable Income. The phrase as used in the law includes interest, rent, salaries, wages, premiums,

1 Revenue Act of 1917, § 9 and § 1212.
2 Revenue Act of 1918, § 221.
3 Id. § 237.
4 Id. § 221; Reg. 45, Art. 361.

annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, but expressly excludes income received as dividends from a corporation taxable upon its net income. It also expressly excludes interest on bonds, mortgages or similar obligation of corporations containing covenants to pay the tax.[5] Under the 1913 and 1916 Laws, the Treasury Department defined the term in its various aspects in a series of regulations, as follows:[6]

COMMISSIONS. Where an individual works on a straight commission basis and, in earning his commissions, incurs and personally pays traveling and other expenses, the amounts paid to him as commissions are not fixed or determinable income. If the agent incurs and pays no necessary business expenses in earning his commissions, the amount paid him is fixed and determinable income.[7]

PROFIT SHARINGS. The amount received as a share of the profits of the employer is fixed and determinable income.[8]

BONUS. A bonus paid in addition to salary is fixed and determinable income,[9] unless it is a mere gift or gratuity.

SALARIES. *Per diem* salaries paid on a straight basis of compensation for services rendered are fixed and determinable income, unless the employee is required by the terms of his employment or contract to pay therefrom his own traveling and other legitimate expenses incident to the business of his employment.[10] It is held that salaries, wages and commissions, paid by domestic corporations, resident individuals, or partnerships to non-resident alien employees for services rendered entirely in a foreign country are not subject to deduction and withholding of the normal tax, and such payments of income will not be subject to the

[5] Id. § 221.

[6] Compare Rev. Act of 1918, § 221 and § 256.

[7] Letter from Treasury Department dated January 12, 1917; I. T. S. ¶ 1016.

[8] T. D. 2090.

[9] T. D. 2135.

[10] Id.

income tax in the hands of the recipient as from a source within the United States.[11]

Rent. Rent is fixed and determinable income subject to withholding, and this is true whether payment is made in cash or in notes.[12] Where permanent improvements are made by a tenant under the terms of a lease the value thereof is considered income to the landlord to be accounted for by the landlord as gain or profit at the termination of the lease, but the amount is not fixed or determinable income.[13] Rent paid by domestic corporations, resident individuals, or partnerships to non-resident aliens as rent for property located in a foreign country is not subject to collection at the source.[14]

Partnership Salaries. Salaries stipulated by contract or articles of agreement between partnership members constitute fixed and determinable income. But where, by agreement or otherwise, members of the firm are permitted to draw either stated or unstated sums in advance of an annual or periodic determination of partnership profits, no withholding is required, as these sums do not represent fixed or determinable income within the meaning of the law.[15] Withholding seems not to be required against the partners on payment of the net distributive shares of the income of the partnership.

Exempt Income. Although exempt income may be fixed and determinable, no withholding is required upon the payment thereof.[16]

Promissory Notes. When a note is given in payment of fixed and determinable income the duty of withholding the tax is imposed upon the maker of the note.[17]

Interest. Interest as a general rule is held to be fixed

11 Reg. 33 Rev., Art. 32.
12 T. D. 2090.
13 T. D. 2442.
14 Reg. 33 Rev., Art. 32.
15 Memorandum from Treasury Department, I. T. S. 1917, ¶ 2282.
16 T. D. 1890.
17 Reg. 33, Art. 68.

or determinable income and subject to withholding,[18] and banks are required to withhold on interest paid to non-resident alien individuals or foreign corporation not engaged in business in the United States and not having an office or place of business therein.[19]

ROYALTIES. Where royalties or rentals accrue under the terms of a lease or agreement, as for instance, royalties for the right to mine or produce or remove minerals or oil or other natural deposits, the royalty or rental is not fixed or determinable income if it represents a partial return of capital originally invested in the lands by the lessor.[20]

IRREGULAR MISCELLANEOUS INCOME. Income of an individual which is not fixed or certain and not payable at stated periods, or is indefinite or irregular as to amount or time of accrual, is not subject to withholding at the source, such as incomes of farmers, merchants, agents (unless the compensation is in the form of commissions as indicated above), lawyers (except annual retainers), doctors, authors, inventors, and other professional persons whose income is irregular or indefinite.[21]

Dividends. The term dividends as used in this chapter means dividends, as defined in the law.[22] The term includes dividends paid in cash, or other property or in stock of the corporation. Withholding was required under the 1916 Law, as amended, on payments of dividends to foreign

18 Reg. 33, Art. 67.

19 T. D. 2652. Although this Treasury Decision expressly stated that withholding was required only with respect to interest paid to non-resident aliens, the reason for limiting the ruling to individuals does not exist under the 1918 Law. The long established rule that banks were not required to withhold on interest paid or accruing on deposits was revoked by this Treasury Decision. It seems that the word "paid," as used therein, is intended to include interest which is actually paid and also interest that is credited to the account of non-resident alien individuals, that is, deduction is to take place when the interest is placed at the depositor's credit.

20 Letter from Treasury Department dated March 10, 1916; I. T. S. 1918, ¶ 180.

21 T. D. 1890; T. D. 2090.

22 Revenue Act of 1918, § 200.

corporations not having an office or place of business in the United States, but is not required under the present law.[23]

Bond Interest. The term as used in this chapter means interest upon bonds, mortgages, or deeds of trust, or similar obligations of domestic corporations.[24] The term does not include interest payments on ordinary bankable commercial paper of corporations or ordinary promissory notes of corporations not exceeding one year in time.[25]

Covenants to Pay the Tax. The term as used in this chapter means a covenant contract or provision in the bonds, mortgage, deed of trust or other similar obligations of a corporation by which the obligor agrees to pay any portion of the income tax imposed by the 1918 Law upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States.[26]

Withholding on Payment of Fixed or Determinable Income. The present law requires withholding only if the owner of the income is a non-resident alien or a foreign corporation not engaged in business within the United States and not having an office or place of business therein. Withholding payments of fixed or determinable income are not subject to withholding when made to a citizen or resident alien, a domestic or resident foreign corporation, or a partnership whether domestic or foreign, resident or non-resident. It should be noted that the withholding provisions apply to ''fixed or determinable annual or periodical gains, profits, and income.'' It would seem therefore that if the payment is not annual or periodical in its nature no withholding is required under the language of the law. Although payments of other income to non-resident aliens

23 Id. § 221.
24 Id.
25 T. D. 2090.
26 Revenue Act of 1918, § 221.

are not subject to withholding at the source, the resident in this country having receipt, control or custody of such income may be required, as agent for the non-resident principal to report the amount of such income and to account for the normal tax and the surtax thereon, as indicated in a preceding chapter.[27] Persons paying fixed or determinable annual or periodical income (other than dividends from corporations liable to the income tax and interest upon corporate bonds containing a tax-free covenant clause) are required by the law to deduct and withhold such sums as will be sufficient to pay a tax of 8%; and in the case of a fixed or determinable annual or periodical income (other than dividends from corporations liable to the income tax and interest upon the corporate bonds containing a tax-free covenant clause) payable to a foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein are required by law to deduct and withhold such sums as will be sufficient to pay a tax equal to 10%.[28]

Withholding on Payment of Interest on Bonds Containing Covenants to Pay the Tax. In any case where bonds, mortgages, or deeds of trust or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by the 1918 Law upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permited to pay thereon or to retain therefrom under any law of the United States, the corporation or its withholding agent is required to deduct and withhold a tax equal to 2% of the interest if paid to (a) an individual whether citizen or resident or non-resident alien; (b) a partnership whether domestic or foreign resident or nonresident and (c) a foreign corporation not engaged in business in the United States and not having an office or place

27 See Chapter 6.

28 Revenue Act of 1918, § 221 and § 237; Reg. 45, Art. 361.

of business therein.[29] In all such cases the tax to be withheld is at the rate of 2% of the interest paid regardless of the status of the payee. Although the law requires deduction of tax at higher rates in the case of payments of other income to non-resident aliens and foreign corporations not having an office or place of business in the United States, in the case of interest of this character only 2% is withheld and the recipient of the interest is required to account in his personal return for the remainder of the tax that may be due thereon. The corporation is relieved from withholding in the case of interest payments on such bonds only when the citizen or resident entitled to receive such interest files with the withholding agent on or before February 1 of the year following that in which the interest is received a signed notice in writing claiming the benefit of the personal exemption or the exemption for dependents specied in Section 216 of the law, or both. In the case of non-resident aliens withholding is at present required regardless of whether or not the non-resident alien may in his personal return be allowed to claim the personal exemption.[30] The practical effect of these provisions of the law is that where a corporation has issued bonds containing a covenant to pay the tax it will be required to go through the motions of withholding 2% on all payments to bondholders other than domestic corporations and foreign corporations having an office or place of business in this country, unless in the case of citizens or residents a certificate is filed claiming exemption from the tax on such income. No tax will actually be withheld, since the interest will be paid in full under the terms of the covenant, and the corporation will pay a tax equivalent to the amount theoretically withheld. The recipient of the interest will

29 Revenue Act of 1918, § 221 and § 237. This provision is inserted in the law for the purpose of shifting the burden of the tax from the bondholder to the debtor corporation, a burden the corporation would generally not be required to assume were it not for the provision that the tax be withheld at the source.

30 Revenue Act of 1918, § 221; Reg. 45, Art. 362.

report in his return of income the full amount of the interest received but he will deduct from the amount of tax otherwise payable thereon a sum equal to 2% of the total amount of such interest. If a citizen or resident is not subject to the income tax by reason of the personal exemption to which he is entitled, he should file with the debtor corporation on or before February 1st the year following that in which the interest was paid, a certificate claiming exemption, as otherwise he will subject the paying corporation to an expense of 2% of the amount of the interest paid him, although no tax is due thereon.

CAR-TRUST CERTIFICATES. Car-trust certificates are held to be obligations similar to corporate bonds and mortgages. The trustees are, therefore, required to withhold the tax at the rate of 2% if the certificates contain a contract or provision by which the obligor agrees to pay any portion of the income tax imposed upon the obligee or reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required to pay.[31]

Against Whom the Tax Is Withheld. Although the foregoing paragraphs indicate the classes of taxpayers against whom a tax is withheld the law will be restated under this heading for the sake of convenient reference.

CITIZENS AND RESIDENTS. No tax is withheld on payments to citizens and residents except in cases where interest is paid on any bonds or similar obligations of corporations containing covenants to pay the tax, in which case the tax is required to be withheld at the rate of 2%.

NON-RESIDENT ALIENS. In the case of payments of interest on bonds of corporations containing covenants to pay the tax, the tax is withheld at the rate of 2%. In all other cases where payment is made of fixed or determinable annual or periodical gains, profits or income the tax is withheld at the rate of 8%.

FIDUCIARIES. The tax is withheld on payments to fidu-

31 Reg. 33 Rev., Art. 188.

ciaries who are citizens or residents of the United States and who have an office or place of business therein in the same manner and to the same extent as in the case of citizens and residents, whether or not the fiduciary is an individual or corporation. The tax is withheld on payments to foreign fiduciaries in the same manner and to the same extent as in the case of non-resident aliens whether the fiduciary is an individual or a corporation. Fiduciaries are subject to all the provisions of the law which apply to individuals.[32]

Partnerships. On payments to partnerships, whether domestic or foreign, resident or non-resident, of interest on bonds of corporations containing covenants to pay the tax, the tax is withheld at the rate of 2%. No tax is withheld on payment of any other form of income.[33]

Corporations. No tax is withheld in any case on payment of income to domestic corporations or to foreign corporations which are engaged in business or trade in the United States or have an office or place of business therein. In the case of foreign corporations which are not engaged in business within the United States and do not have an office or place of business therein the tax is withheld at the rate of 2% on all payments of interest on bonds of corporations containing covenants to pay the tax; and at the rate of 10% on all other fixed or determinable annual or periodical gains, profits or income.[34]

Agents. The fact that an individual, partnership or corporation may have an agent within this country to collect and receive income, does not operate to prevent withholding of the tax on payments of income to such agent in cases where payments of income direct to the principal would be subject to withholding. The appointment of an agent in this country does not, in itself, establish the residence of the principal in this country, for the purpose of the income tax, nor does such appointment exempt the non-

[32] Revenue Act of 1918, § 225 and § 221; Reg. 45, Art. 371.
[33] Id. § 221; Reg. 45, Art. 361.
[34] Id. § 221 and § 237; Reg. 45, Art. 361.

resident foreign corporation from the withholding provisions unless, in addition to the appointment of the agent, the corporation is engaged in business in this country or has an office or place of business herein. Agents of non-resident aliens, or foreign corporations subject to the withholding provision should proceed, in collecting income from their principals, in the same manner as the principals would proceed in acting for themselves.

Unknown Owners. Withholding in all cases at the highest applicable rate is required from interest on bonds or other securities where the owner of such securities is unknown to the withholding agent.[34a] This seems to mean that if the bond or other security is one which does not contain a covenant to pay the tax withholding shall be at the rate of 10%, but if the security is a bond of a corporation containing a covenant to pay the tax withholding shall be at the rate of 2%.

Who Are Required to Withhold Tax. Under the 1918 Law it is required that all individuals, corporations and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States, having the control, receipt, custody, disposal, or payment, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income shall withhold the tax, when withholding is required by reason of the status of the recipient of the income. It has been held that a foreign corporation having a fiscal agency in this country is required to withhold a tax of 2% upon the interest upon its tax-free covenant bonds.[35] Lessees and tenants paying rent to non-resident aliens, or their agents, on property located in the United States are required to withhold the tax, as rent is fixed or determinable income

[34a] Reg. 45, Art. 361.

[35] Reg. 45, Art. 361; letters from Treasury Department dated July 9. 1918 (I. T. S. 1918, ¶ 3612) and July 18, 1918 (I. T. S. 1918, ¶ 3613).

within the meaning of the law. But no withholding is required on payments of rent with respect to property located in a foreign country.[36] Employers are required to withhold on payments of salaries or wages to non-resident aliens unless the compensation is paid for services rendered entirely in a foreign country.[37]

DUTY OF EMPLOYER TO DETERMINE STATUS OF ALIEN EMPLOYEES. Aliens employed in the United States are *prima facie* regarded as non-residents. If wages are paid without withholding the tax the employer should be provided with written proofs of facts which overcome the presumption that such alien is a non-resident. Such facts include the following: (a) if an alien has been living in the United States for as much as one year immediately prior to the time he entered the employment of the withholding agent. or if he has been regularly employed by a resident (individual or corporation) in the same county for as much as three months immediately prior. he may be treated as a resident in the absence of facts known to the employer showing that he is in fact a transient[38] (the facts with regard to the length of time the alien has thus lived in the country or county and has been so regularly employed may be established by the certificate of the alien); (b) the employer may also obtain evidence to overcome the *prima facie* presumption of non-residence by securing from the alien Form 1078 (Revised), properly executed or an equivalent certificate of the alien establishing residence. Having secured such evidence from the alien the employer may rely thereon unless the statement of the alien was false and the employer has reasonable cause to believe it

36 Reg. 33 Rev., Art. 32.

37 Id.

38 A typical transient is one who stops for a short time in the course of a journey through the United States, sometimes performing labor, sometimes not, or one who enters the United States intending only to stop long enough to carry out some purpose, object, or plan not involving an extended stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute an alien a transient. (Reg. 45, Art. 311.)

false, and may continue to rely thereon until the alien ceases to be a resident.[39] An employer who seeks to account for failure to withhold in the past, if he did not secure Form 1078 (Revised) or its equivalent at the time, is permitted to prove the former status of the alien by any material evidence.[40]

DUTIES OF ASSIGNEES. Where in connection with the sale of its property payment of the bonds or other obligations of a corporation is assumed by the assignee, such assignee, whether an individual, partnership, corporation, or a state or political subdivision thereof, must deduct and withhold such taxes as would have been required to be withheld by the assignor had no such sale and transfer been made.[41]

Exemption from Withholding. Withholding from interest on bonds or other obligations containing a tax-free covenant shall not be required in the case of a citizen or resident alien individual if he files with the withholding agent when presenting interest coupons for payment, or not later than February first following the taxable year, an ownership certificate on Form 1001 (Revised) claiming a personal exemption or credit for dependents. To avoid inconvenience a resident alien individual should file a certificate of residence on Form 1078 (Revised) with withholding agents, who shall forward such certificates to the Commissioner (Sorting Division) with a letter of transmittal. Notwithstanding the provisions of Section 217 of the statute, withholding is required from income of a non-resident individual.[42]

[39] An alien who has established a residence in the United States continues to be a resident until he or his family evidence an intention to change their residence to another country by starting to remove which may be evidenced for instance by application for passports. They are regarded as residents for that portion of the taxable year which elapsed up to the time such step was taken. (Reg. 45, Art. 313.)

[40] Reg. 45, Art. 314.

[41] Id. Art. 363.

[42] Reg. 45, Art. 362.

Ownership Certificates. The owners of bonds or other obligations, whether or not containing a tax-free covenant, issued by domestic or resident corporations, when presenting interest coupons for payment shall file a certificate of ownership for each issue of bonds, showing the name and address of the debtor corporation, the name and address of the owner of the bonds, whether the payee is married or the head of a family or has other dependents, the nature of the obligations, the amount of interest and its due date, and the amount of any tax withheld. No ownership certificates need be filed in the case of interest payments on bonds the income from which is not included in gross income, nor in the case of any obligations of the United States.[43] Ownership certificates executed by the owner must indicate whether or not he is married or the head of a family.[44] But if he states that he is married it is not also necessary that he state that he is head of a family.[45] Ownership certificates should not be accepted unless all information called for thereon is shown including information regarding the marital status and head of family.[46] Coupons of more than one maturity from the same issue of bonds may be covered by one ownership certificate.[47] When bonds are owned jointly by several persons one of the owners may execute an ownership certificate in behalf of the others and indorse on the back thereof the names and addresses of all the joint owners and the proportion of ownership of each. Separate certificates need not be filed by each joint owner.[48] Separate ownership certificates must be executed for each estate or

[43] Id. Art. 363.

[44] Letter from Treasury Department dated March 26, 1918; I. T. S. 1918, ¶ 3234.

[45] Letter from Treasury Department dated March 30, 1918; I. T. S. 1918, ¶ 3235.

[46] Telegram from Treasury Department dated February 28, 1918; I. T. S. 1918, ¶ 3146.

[47] Letter from Treasury Department dated March 26, 1918; I. T. S. 1918, ¶ 3233.

[48] T. D. 2709, revoking T. D. 1987; Reg. 45, Art. 371.

trust controlled by a fiduciary regardless of the fact that bonds held by two or more of such estates or trusts may be of the same issue.[49] A fiduciary whether corporate or individual should use the lines on the ownership certificates provided for the use of a fiduciary. Citizens or resident fiduciaries should use Form 1000, line 1, or Form 1001, line 1 or line 2. Non-resident alien fiduciaries should use Form 1000, line 2.[50] Partnerships composed of citizens and residents of the United States and non-resident aliens in collecting interest on bonds of domestic or resident corporations should use line 3 if the principal office is in this country and line 4 if the principal office is abroad, on Form 1001.[51] The address may be omitted from ownership certificates in the case of prominent corporations and in its place a description of the bond issue may be inserted.[52] Interrogatories as to the marital status on ownership certificates need not be answered when certificates are executed by non-resident alien individuals.[53] Form 1002 is obsolete. If coupons are not accompanied by certificates disclosing ownership, Form 1000 (Revised) must be made out by the first bank which will enter the amount of interest on line 4.[54] If the ownership certificate is signed by an agent it is not necessary for the first bank or collecting agency to endorse the certificate with the words "Satisfied as to identity and responsibility of agent," [54a] as was formerly required under the 1916 Law.

49 Id.

50 Letter from Treasury Department dated May 20, 1918; I. T. S. 1918, ¶ 3363.

51 Telegram form Treasury Department dated May 21, 1918; I. T. S. 1918, ¶ 3364.

52 Telegram from Treasury Department dated February 11, 1918; I. T. S. 1918, ¶ 3079.

53 Telegram from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3380.

54 Telegram from Treasury Department dated January 28, 1918; I. T. S. 1918, ¶ 3072.

54a Letter from Treasury Department dated March 26, 1918; I. T. S. 1918, ¶ 3232.

Form of Certificate Where Withholding Required. Form 1000 (Revised) shall be used (a) by citizens or residents of the United States when no personal exemption or credit is claimed against interest on bonds containing a tax-free covenant; (b) by non-resident alien individuals and foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, whether or not such bonds contain a tax-free covenant; (c) by partnerships, resident or non-resident, in the case of bonds containing a tax-free covenant; and (d) where coupons are received not accompanied by certificates of ownership. The first bank receiving coupons not accompanied by ownership certificates will make a certificate, crossing out "owner" and inserting "payee," and will enter the amount of interest in the space provided for unknown ownership.[55]

Form of Certificate Where No Withholding Required. Form 1001 (Revised) shall be used (a) by citizens or residents of the United States when personal exemption is claimed against interest on bonds containing a tax-free covenant and when presenting coupons from bonds not containing a tax-free covenant; (b) by domestic corporations; (c) by partnerships, resident or non-resident in the case of bonds not containing a tax-free covenant; and (d) by foreign corporations engaged in trade or business within the United States or having an office or place of business therein, whether or not such bonds contain a tax-free covenant. In case a citizen or resident alien individual receives interest on bonds containing a tax-free covenant in excess of the amount of personal exemption which the individual may claim, any such excess must be reported on Form 1000 (Revised).[56]

Use of Substitute Certificates. Resident collecting agents, responsible banks and bankers, receiving interest coupons for collection with ownership certificates attached,

[55] Reg. 45, Art. 364.
[56] Id. Art. 365.

may present the coupons with the original certificates to the debtor corporation or its duly authorized withholding agent for collection or may detach and forward the original certificates direct to the Commissioner, provided each such collecting agent shall substitute for such original certificates its own certificates (Form 1058 (Revised) or Form 1059 (Revised)) and shall keep a complete record of each transaction, showing (a) serial number of item received; (b) date received; (c) name and address of person from whom received; (d) name of debtor corporation; (e) class of bonds from which coupons were cut (whether containing a tax-free covenant or not); and (f) face amount of coupons. For the purpose of identification the substitute certificates shall be numbered consecutively and corresponding numbers given the original certificates of ownership. The use of substitute certificates by collecting agents, banks and bankers is not permitted, however, in the case of ownership certificates presented with coupons for collection by non-resident alien individuals, partnerships, or corporations.[57] Substitute certificates may be used in connection with payments of income made to the alien property custodian.[58]

Return of Tax Withheld. (a) Every withholding agent shall make an annual return to the collector of the tax withheld from interest on corporate bonds or other obligations on or before March 1 on Form 1013 (Revised). He shall also make a monthly return on Form 1012 (Revised) on or before the 20th day of the month following that for which the return is made. The original ownership certificates, or the substitute certificates where authorized, must be forwarded to the collector with the monthly return. (b) Every person required to deduct and withhold any tax from income other than such bond interest shall make an annual return thereof to the collector on or before March 1 on Form 1042 (Revised),

57 Id. Art. 366.

58 Letter from Treasury Department dated June 6, 1918; I. T. S. 1918, ¶ 3518.

accompanied by a separate report on Form 1098 (Revised) for each non-resident alien individual or foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein, to whom income other than bond interest was paid during the previous taxable year. In every case of both classes the tax withheld must be paid on or before June 15th of each year to the collector.[59]

Withholding in 1918. In cases prior to the date of the passage of the Revenue Act of 1918, where a withholding agent pursuant to the Revenue Acts of 1916 and 1917 withheld only 2 per cent. from the income of non-resident alien individuals, he need return only such sum. In all such cases where a withholding agent withheld the tax pursuant to the Revenue Acts of 1916 and 1917 from the income of foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, he need return only the sum withheld, to an amount not in excess of the aggregate sum required to be withheld by the terms of the Revenue Act of 1918 from the income paid over by the withholding agent.[60]

Release of Excess Tax Withheld. Any sum withheld for tax since December 31, 1917, in excess of the amount prescribed by the Revenue Act of 1918, shall be released by the withholding agent and paid over to the person from whom it was withheld or his proper representative. With reference to how a debtor corporation may release and pay over the amount of tax so withheld in a case where a bank or other collection agency detached the ownership certificate which accompanied an interest coupon and substituted its own certificate (Form 1059), which does not disclose the name and address of the bond owner, in such cases the withholding agent shall request the bank or collection agency to disclose the name and address of the

59 Reg. 45, Art. 367.
60 Id. Art. 368.

owner of the bonds, as shown by the original certificate, and it shall be the duty of the bank or collection agency to make such disclosure to the withholding agent. Where withholding agents have so released any excess of tax, an itemized statement showing the names, addresses and amounts refunded should be attached to the annual list returns (Form 1013), in order to reconcile any discrepancy between the aggregate amount of taxes returned as shown by the monthly list returns (Form 1012) and the aggregate amount as shown by the annual list return.[61]

Use of Information Return Where No Actual Withholding. Where a debtor corporation or its duly authorized withholding agent has made no payments of interest to non-resident alien individuals or foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, or to unknown persons, and has withheld no tax from interest payable to citizens or residents of the United States, individuals or partnerships, whether or not the bonds upon which such interest accrued contained a tax-free covenant clause, the ownership certificates filed in connection with such interest payments shall not be forwarded to collectors, accompanied by a return on Form 1012 (Revised), but shall be transmitted directly to the Commissioner (Sorting Division), accompanied by a letter of transmittal. This return shall be made monthly and need not be sworn to. The number of ownership certificates thus transmitted and the total amount of interest paid shall be entered in the return.[62]

Withholding in the Case of Enemies. Payments made after October 6, 1917, to the alien property custodian are in the same category as payments made to or for citizens or residents of the United States. Withholding at the source is accordingly unnecessary except in the case of interest payments on corporate bonds or other obligations

61 Id. Art. 369.
62 Id. Art. 370.

containing a tax-free covenant where no exemption is claimed. The alien property custodian should use Form 1000 (Revised) in collecting interest on bonds containing a tax-free covenant and in all other cases should use Form 1001 (Revised). No distinction is to be made between payments directly to the alien property custodian and to his depositaries and between interest on registered bonds and interest on coupon bonds. In the case of enemies or allies of enemies holding a license granted under the provisions of the Trading with the Enemy Act, withholding is required as in the case of any non-resident alien not an enemy or ally of enemy.[63] Where ownership certificates Form 1000 or Form 1001 is executed to cover funds paid over to the Alien Property Custodian, the certificate is sufficiently complete if the name of the taxpayer and the trust number are given under the heading owner of bonds with the name and address of the enemy or ally of enemy concerned excluded.[64]

[63] Id. Art. 372.

[64] Letter from Treasury Department dated July 13, 1918; I. T. S. 1918, ¶ 3608.

CHAPTER 41

COVENANTS TO PAY TAXES

Covenants to pay taxes are contained in bonds, mortgages, notes, leases, and similar instruments whereby it is stipulated that the debtor, lessee, or other payor shall pay the interest, rent, or other income without deduction for taxes. Many such covenants became operative under the 1913 Law, and the 1916 Law prior to its amendment by the Act of October 3, 1917, by reason of the requirement in those laws that the normal tax should be withheld at the source. They operate under the 1916 Law as amended and under the present law only in certain cases and to a limited extent. Such covenants for the purpose of this discussion may be divided into two classes: (1) those which are contained in bonds, mortgages, or deeds of trust, or other similar obligations of a corporation and (2) those contained in other instruments. Those contained in other instruments operate only when the payee is a non-resident alien or a foreign corporation not engaged in business within the United States and not having an office or place of business therein, unless the covenant is so broad that it imposes an obligation on the payer notwithstanding that the interest, rent, or other payments thereunder are made in full without deduction of any tax at the source. Covenants of the first class stated above may be of two kinds: (a) those which agree to assume the tax of the payee only to the extent that the interest specified in the obligation shall be paid in full and (b) covenants which may be so broad in their terms as to obligate the debtor to reimburse the creditor for any tax which may be imposed upon him

with respect to the interest after it has been received in full by the creditor. Covenants broad enough to fall within the second class are very unusual and are not covered by the discussion in this chapter. Those covenants to pay the tax which are embraced within the language of Section 221, subdivision (b) of the statute and discussed in this chapter are only those which have all the following qualifications: (a) they must be made by corporations; (b) they must be contained in bonds, mortgages, deeds of trust, or other similar obligations, and (c) they must be such as to bind the corporation-debtor to pay some portion of the tax imposed by the Revenue Act of 1918 on the creditor, or to reimburse the creditor for any portion of the tax, or to pay the interest without deduction for any tax which the debtor may be required or permitted to pay thereon or to retain therefrom under any law of the United States. Where payment of interest is made under such covenants a tax equal to 2% of the interest is required to be withheld at the source if the owner of the bonds or similar obligations is (a) an individual, whether citizen, resident, or non-resident alien ; (b) a partnership, whether domestic or foreign, resident or non-resident; (c) a foreign corporation not engaged in trade or business within the United States and not having an office or place of business therein. The Commissioner may require the tax to be withheld where the owner of the bonds is unknown to the withholding agent, but no withholding is required against unknown owners unless and until the Commissioner so orders. The tax is not required to be withheld on payments to domestic corporations or to foreign corporations having an office or place of business in the United States but is required to be withheld on payments to a fiduciary although the fiduciary may be a corporation

The tax cannot be withheld except against payees specified in the statute. If the bond contains a covenant to

[1] Revenue Act of 1918, §§ 221 and 237.

pay the tax but the mortgage does not, or *vice versa,* the tax must be withheld under this provision. If the covenant specifies that a tax of 1% will be paid 2% must nevertheless be withheld; 1% being assumed by the debtor corporation and the other 1% by the bondholder. In such cases only 99% of the full amount of interest should be paid to the bondholder. If the covenant specifies that more than 2% will be paid by the debtor corporation only 2% may be withheld, the covenant being inoperative under the law with respect to any additional amount specified therein. If the bond, mortgage, deed of trust, or similar obligation does not contain a contract or provision obligating the debtor (a) to pay some portion of the tax imposed by the Revenue Act of 1918 on the creditor, or (b) to reimburse the creditor for any portion of the tax, or (c) to pay the interest without deduction for any tax which the debtor may be required or permitted to pay thereon or to retain therefrom under the laws of the United States, the debtor corporation cannot voluntarily undertake to withhold the tax under this provision and thereby assume the tax for its bondholders. In the case of payments to non-resident aliens or foreign corporations having no office or place of business in this country, only 2% may be withheld on obligations containing tax-free covenants, notwithstanding that on other income 8% or 10% is required to be withheld in such cases. Obligations of individuals or partnerships, whether or not containing tax-free covenants are not such as authorize withholding at the 2% rate or at any rate against citizens, residents, domestic corporations, or foreign corporations having an office or place of business in this country. Obligations of corporations other than bonds, mortgages, deeds of trust or similar obligations are not such as authorize withholding at the 2% rate or at any rate against citizens, residents, domestic corporations, or foreign corporations having an office or place of business in this country.

Withholding the tax at the source at the rate of 2% on interest paid with respect to obligations containing

tax-free covenants is not a measure designed or intended to insure the collection of revenue, as is withholding at the source generally, but is a measure whereby corporations may be compelled to pay a part of the tax which would otherwise be imposed upon the bondholder. The provision is inserted in the law on the theory that since corporations have issued bonds agreeing to pay the interest in full without deduction for any tax which might be required to be withheld at the source and presumably that provision has influenced either the price at which the bonds were sold or at the rate of interest, the law should be adapted to the end that the corporation be compelled to assume some part of the tax of the bondholder. Apparently the entire normal tax was deemed to be too great a burden and 2% was considered appropriate. No reason is advanced, however, for excluding bondholders which are domestic corporations from the benefits accruing to bondholders who are individuals and partnerships under "tax-free covenants" by this adaptation of the law, notwithstanding that among domestic corporations are savings banks and insurance companies where the advantage would inure ultimately to the benefit of depositors or policyholders.

Since there is a requirement in the law that a 2% tax be assumed by the corporation on interest paid to a large proportion of its bondholders where the bond contains a tax-free covenant it becomes a matter of importance to officers of corporations to determine whether or not the covenants in the bonds or mortgages of the corporation are broad enough in general language, or specific enough, to require the corporation to assume the burden under the present income tax. Unless there is a legal obligation to pay the tax, or any part thereof for the bondholder, the officers of the corporation may incur liability by making such payments, since if there is no legal compulsion, the payment of the tax of a bondholder is a diversion of the funds of the corporation to which stockholders and creditors may object and for which the officers may

incur personal liability. Further, unless there is a legal obligation the corporation is not authorized under the law to pay the 2% tax for its bondholders, and the corporation may incur liability for not withholding the proper amount of tax on payments to non-resident aliens or foreign corporations having no office or place of business in this country. The law requires that if the bond contains a covenant to pay the tax only 2% shall be withheld and if the bond does not contain the covenant 8% shall be withheld on payments to non-resident aliens. There is no authority in the law for withholding 8% and assuming to pay all or only 2% for the bondholder. Either the obligation is one which requires withholding at the rate of 2% and the assumption of the tax by the corporation or is one which requires withholding at the rate of 8% on payments of interest to non-resident aliens and the assumption of no part of the tax by the corporation. An examination of the covenant in each mortgage or issue of corporation bonds is therefore essential.

A covenant reading as follows does not require or authorize the corporation to assume any part of the income tax of its bondholders:

"Both principal and interest of this bond are payable without deduction for any taxes, assessments or other governmental charges which the company may be required to pay thereon or authorized to retain therefrom under any present or future law or requirement of the United States of America (except any Federal Income Tax) or any State, county, municipality or other governmental subdivision thereof." [2]

Many covenants to pay taxes were entered into prior to the enactment of the 1913 Law, and without contemplation of an income tax law requiring collection at the source.

[2] Letter from Treasury Department dated November 21, 1917; I. T. S. 1918, ¶ 810.

In such covenants no specific reference is made to an income tax and the force of the covenant with respect to the present income tax depends upon the general language used therein. One typical form reads as follows:

"Both the principal and interest of this bond are payable without deduction for any tax or taxes, assessment or assessments, or other Governmental charges, which the company may be required or permitted to pay thereon, or to retain therefrom, under any present or future law of the United States, or of any state, county, municipality or other lawful taxing authority thereof."

Whether this form of covenant requires the corporation to pay the income tax of the bondholder, or only such taxes as are imposed on the bond or interest, as such, is an unsettled question. In a recent case it was held that a clause in bonds issued by a corporation promising payment "without deduction from either such principal or interest, for any tax or taxes, which the Marion Hotel Company may be required to pay or retain therefrom, under any present or future law, the Marion Hotel Company agreeing to pay such tax or taxes," did not require the corporation to pay the Federal income tax of the bondholder which it retained from the payment of interest on the bonds, since the tax is not a tax on the bond, but a personal obligation of the bondholder, arising out of the possession of an income in excess of the exemptions and deductions allowed by such law.[3] The Supreme Court of Massachusetts in deciding whether the income tax came within the terms of a covenant by a lessee to pay "all taxes and assessments * * * upon or in respect of the rent * * * howsoever and to whomsoever assessed," held that the 1913 Law imposed the tax "in respect of the rent" and held that the language quoted was effective to compel the tenant to assume the tax of the

3 Urquhart v. Marion Hotel Co., (Ark.) 194 S. W. 1. The court referred to the early cases of Haight v. Railroad Co., 6 Wall. 15; Baltimore v. Baltimore R. R., 10 Wall. 543.

landlord to the extent that the law required the amounts thereof to be withheld at the source.[4]

Other covenants provide that the debtor "will pay the principal and interest of these bonds without deduction for taxes." It is a question whether or not covenants of this kind are broad enough to include taxes upon the bondholder as well as taxes assessed against the corporation upon the mortgage or bond or interest. Where a lease provided that the lessee should "pay all taxes and assessments—upon the yearly payments herein agreed to be made by the party of the second part to the party of the first part—for the payment or collection of which taxes or assessments the said party of the first part would otherwise be liable or accountable under any lawful authority whatever;" and that the lessee "should pay all taxes, charges, levies, claims, liens and assessments of any and every kind, which during the continuance of the term hereby demised, shall, in pursuance of any lawful authority, be assessed or imposed upon the demised premises, or any part thereof—all payments required to be made by the party of the first part during the term of this indenture—shall be assumed and discharged by the party of the second part as if the party of the second part were primarily liable for same," it was held that the lessee was liable for the income tax of the lessor on the ground that it was the apparent intention of the parties that the lessor should receive the amounts stipulated as rent without deduction by reason of any tax, charge or assessment of any kind and that the language was suffi-

[4] Suter v. Jordan Marsh Company, (Mass.) 113 N. E. 580. The court seemed to rest its decision in this case on the conclusion that the tax was levied upon the separate sources from which a part of the net income was derived. This conclusion appears to be against the weight of authority that the tax is on the person and not on his property. If such conclusion had been reached by the court it seems from the opinion that the decision might have been different. See, however, Catawissa R. R. Co. v. Phila. & Reading Co., 255 Pa. 269, where the court held that the income tax was "imposed upon rental received by the lessor from the lessee."

ciently broad to cover the Federal income tax although not enacted at the time the lease was made.[5] In another case where a covenant provided that the specified rent should be paid "without any deduction, defalcation or abatement for any taxes, charges or assessments whatsoever, * * * it being the express agreement of the said parties that the said covenantor, his heirs and assigns, shall pay all taxes whatsoever that shall hereafter be laid, levied or assessed by virtue of any law whatever, as well on the said hereby granted lot and buildings thereon erected or to be erected as on the said yearly rental now charged thereon" it was held that the covenant did impose an obligation upon the lessee to pay the Federal income tax since it was manifestly the intention of the parties, by this covenant, to secure to the grantor the full payment of the yearly rent without any deduction, defalcation or abatement for any taxes, charges or assessments whatsoever.[6] Again, where a lease provided that the lessee should "pay all taxes, charges and assessments * * * imposed under any existing or future law on the demised premises, or any part thereof, or on the business there carried on, or on the gross receipts or net, derived therefrom, or upon the capital stock of 'the lessor' or the dividends thereon, or upon the franchises of the said company, for the payment or collection of any of which said taxes the 'lessor' may otherwise become liable" it was held that the lessee was not required to pay the Federal income tax on the rental received by the lessor on the ground that such tax was not expressly mentioned and the covenant was not broad enough to discharge all liability for taxes of every kind for which the lessor should become primarily liable.[7]

[5] Northern Pennsylvania R. R. Co. v. Philadelphia & Reading Ry. Co., 43 Pa. C. C. 150; aff'd 249 Pa. 326.

[6] Van Beil v. Brogan, 65 Pa. Super. 384 reversing 23 D. R. 1055 (Dauphin County Court, Pa. 1914). Erlich v. Brogan, 262 Pa. 362.

[7] Little Schuylkill, etc., Co. v. Philadelphia & Reading Ry. Co., 44 P. A. County Ct. Rep. 197, aff'd 69 Pa. Super. 122. Allocatur to

The cases referred to above are cases which have been decided under the 1913 or 1916 Laws. Other cases arising under different statutes are referred to in the foot note.[8]

the Supreme Court has been denied. It seems in this case the intention of the lessor was to have the lessee pay any and all taxes so that the net amount of the rental could be distributed without diminution to the stockholders, but the court held that the language of the covenant was not broad enough to so hold.

[8] Northern Trust Co. v. Buck, 263 Ill. 222, 104 N. E. 1114, Pettibone v. Smith, 150 Pa. 118, 24 Atl. 693; Chicago, etc., Ry. v. Kansas City N. W. R. R., 75 Kans. 167, 88 Pac. 1085; Erie, etc., R. R. v. Pennsylvania R. R., 208 Pa. 506, 57 Atl. 980; Clopton v. Phila. & Reading R. R. Co., 54 Pa. 356; Northern Central R. R. Co. v. Jackson, 7 Wall. 262; U. S. v. Baltimore & Ohio R. R. Co., 17 Wall. 322. See also article in Illinois Law Review, January, 1915.

CHAPTER 42

CONSTITUTIONALITY OF THE LAW

It is not the purpose of this chapter to discuss exhaustively the constitutional questions which might exist with respect to the present internal revenue laws, but to point out certain features of such laws with respect to which questions of constitutionality have been raised, and also to point out briefly a few general principles which may have a bearing upon the constitutionality of provisions of the Revenue Act of 1918. It is a long established principle vital to our constitutional system that a court is not authorized to adjudge a statute unconstitutional where the question as to its constitutionality is at all doubtful, and that unless the statute is plainly and palpably unconstitutional, it will be upheld. Instead of seeking for excuses for holding acts of the legislative power void by reason of their conflict with the constitution the effort should be made to reconcile them, if possible, and not to hold the laws invalid unless the opposition between the constitution and the laws be such that the court feels a clear and strong conviction of their incompatibility with each other.[1] Unless it be impossible to avoid it, a general revenue statute should never be declared inoperative in all its parts because a particular part, relating to a distinct subject, is invalid. It is an elementary principle that the same statute may be in part constitutional and in part unconstitutional, and that if the parts are wholly inde-

[1] Booth v. Illinois, 184 U. S. 431; Fletcher v. Peck, 6 Cranch 87; Brown v. Wallace, 161 U. S. 591; U. S. v. Delaware & H. Co., 213 U. S. 366.

pendent of each other that which is constitutional may stand and that which is unconstitutional will be rejected. It is only when different clauses of an act are so dependent upon each other that it is evident the Legislature would not have enacted one of them without the other—as when the two things provided are necessary parts of one system—that the whole Act will fall with the invalidity of one clause. When there is no such connection and dependency, the Act will stand, though different parts of it are rejected. A different rule might be disastrous to the financial operation of the government and produce the utmost confusion in the business of the entire country.[2] It will be noted that the Revenue Act of 1918 provides expressly that if any clause, sentence, paragraph or part shall for any reason be adjudged by any court of competent jurisdiction to be invalid, such judgment shall not affect, impair or invalidate the remainder of the act, but shall be confined in its operation to the clause, sentence, paragraph or part directly involved in the controversy in which the judgment is rendered.[3]

Power of Congress to Levy Income Taxes. The Sixteenth Amendment to the Federal Constitution authorized Congress "to lay and collect taxes on incomes from whatever source derived, without apportionment." As Chief Justice White has said,[4] this amendment does not confer power to levy income taxes in a generic sense or to limit and distinguish between one kind of income tax and another, but the whole purpose was to relieve all income taxes, when imposed, from apportionment; in short, doing away with the principle upon which the case[5] holding the 1894 Law unconstitutional was decided. The amendment places no limitation as to the nature and character of the income taxes which it authorizes. Con-

[2] Field v. Clark, 143 U. S. 649; Rainey v. U. S., 232 U. S. 308.

[3] Revenue Act of 1918, § 1401.

[4] Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

[5] Pollock v. Farmers Loan & Trust Co., 157 U. S. 429; 158 U. S. 601.

gress derives from the Constitution [6] its powers "to lay and collect taxes, duties, imposts and excises." This power is exhaustive and embraces every conceivable power of taxation, limited only by the constitutional provisions that "all duties, imposts and excises shall be uniform, throughout the United States," [7] that "direct taxes shall be apportioned among the several states" [8] and that "no capitation or other direct tax, shall be laid, unless in proportion to the census." [9] The Sixteenth Amendment removed the limitation of apportionment, but did not enlarge the power of Congress.

Taxing Gains and Profits from Sale of Property. The decision in Gray v. Darlington [10] has sometimes been mentioned as placing a limitation on the power of Congress to tax profits arising from the sale of capital assets, on the ground that the word "income" as used in the Sixteenth Amendment was used in the sense in which it had theretofore been defined in this case.[11] The facts in Gray v. Darlington were that Darlington, who was apparently neither a merchant nor a trader, in 1865, being the owner of certain United States Treasury notes, exchanged them for United States bonds. Two years later the Income Tax Law of 1867 was enacted, and in 1869, two years after the incidence of the tax, he sold the bonds at an advance of $20,000 over the cost of the notes. Upon this amount was levied a tax of five per centum as gains, profits and

6 Constitution of the United States, Art. 1, § 8.

7 Id. Art. 1, § 8, Cl. 1.

8 Id. Art. 1, § 2, Cl. 3.

9 Id. Art. 1, § 9, Cl. 4.

10 Gray v. Darlington, 15 Wall. 63.

11 "* * * The word *income* must be presumed to have been used in the constitutional amendment (16th) in the sense in which the Supreme Court had theretofore defined it, if a judicial definition had been clearly given." Towne v. Eisner, 242 Fed. 702. In reversing this decision (245 U. S. 418) the Supreme Court expressed no disapproval of the statement quoted from the opinion of the lower court, and Judge Hand's remark seems to be a correct statement in general. See also Western Union Tel. Co. v. Julian, 169 Fed. 166.

income of the year 1869. Darlington paid the tax under protest and sued to recover, and prevailed. While the only question before the court was the extent to which Congress had intended by the Act of 1867 to tax gains, profits and income and the decision hinged on a consideration of the particular language of the 1867 Law, the court defined the term income more generally perhaps than was necessary. It is said in part: "The question presented is whether the advance in the value of the bonds, during this period of four years, over their cost, realized by their sale, was subject to taxation as gains, profits or income of the plaintiff for the year in which the bonds were sold. The answer which should be given to this question does not, in our judgment, admit of any doubt. The advance in the value of property during a series of years can, in no just sense, be considered the gains, profits or income of any one particular year of the series, although the entire amount of the advance be at one time turned into money by a sale of the property. The *statute* looks, with some exceptions, for subjects of taxation only to *annual* gains, profits and income. Its general language is 'that there shall be levied, collected and paid annually upon the gains, profits and income of every person,' derived from certain specified sources a tax of five per cent., and that this tax shall be 'assessed, collected, and paid upon the gains, profits, and income for the year ending the 31st of December next preceding the time for levying, collecting, and paying said tax.'[12] This language has only one meaning, and that is that the assessment, collection, and payment prescribed are to be made upon the annual products or income of one's property or labor, or such gains or profits as may be realized from a business transaction begun and completed during the preceding year. There are exceptions, as already intimated, to the general rule of assessment thus prescribed. One of these exceptions is expressed in the

[12] 14 Stat. at Large, pp. 477, 478, § 13

statute, and relates to profits upon sales of real property, requiring, in the estimation of gains, the profits of such sales to be included where the property has been purchased, not only within the preceding year, but within the two previous years. Another exception is implied from the provision of the statute which requires all gains, profits, and income derived from any source whatever, in addition to the sources enumerated, to be included in the estimation of the assessor. The estimation must, therefore, necessarily embrace gains and profits from trade and commerce, and these, for their successful prosecution, often require property to be held over a year. In the estimation of gains of any one year the trader and merchant will, in consequence, often be compelled to include the amount received upon goods sold over their cost which were purchased in a previous year. Indeed, in the estimation of the gains and profits of a trading or commercial business for any one year, the result of many transactions have generally to be taken into account which originated previously. Except, however, in these and similar cases, and in the cases of sales of real property, the statute only applies to such gains, profits, and income as are strictly acquisitions made during the year preceding that in which the assessment is levied and collected. The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits or income specified *by the statute*. It constitutes and can be treated merely as increase of capital. The rule adopted by the officers of the revenue in the present case would justify them in treating as gains of one year the increase in the value of property extending through any number of years, through even the entire century. The actual advance in value of property over its cost may, in fact, reach its height years before its sale; the value of the property may, in truth, be less at the time of the sale than at any previous period in ten

years, yet, if the amount received exceed the actual cost of the property, the excess is to be treated, according to their views, as gains of the owner for the year in which the sale takes place. We are satisfied that no such result was intended by the *statute*."[13]

This decision has been referred to by the Supreme Court in recent cases, but its present force and effect is by no means clear. In one case,[14] arising under the 1909 Law, which imposed an excise tax measured by income, the Supreme Court referred to Gray v. Darlington as follows:

"This court held that by the true construction of the Act, except as to gains and profits from trade and commerce and sales of real property, the statute only applied to such gains, profits and income as were strictly acquisitions made during the year preceding that in which the assessment was levied and collected. We do not regard the decision as controlling, because the language of the Act now under consideration is different in material particulars. As pointed out in Doyle, Collector v. Mitchell Brothers Co., this day decided, it imposes annually a special excise tax with respect to the carrying on or doing business by the corporation 'equivalent to one per centum upon the entire net income over and above five thousand dollars received by it from all sources during such year,' to be ascertained by taking gross income and applying certain exceptions and deductions. 'Gains, profits, and income for the year ending the thirty-first day of December next preceding' (Act of 1867) conveys a different meaning from 'the entire net income * * * received by it * * * during such year' (Act of 1909). The former expression, as this court held (15 Wall. 65), denoted 'such gains or profits as may be realized from a

[13] The italicized words are italicized by the writer as possibly indicative of the point that the Supreme Court meant to confine the application of its statements to the particular statute being considered.

[14] Hays v. Gauley Mountain Coal Co., 247 U. S. 189.

business transaction begun and completed during the preceding year,' with the exceptions already mentioned. The expression 'income received during such year,' employed in the Act of 1909, looks to the time of realization rather than to the period of accruement, except as the taking effect of the act on a specified date (January 1, 1909), excludes income that accrued before that date. There are other differences upon which we need not dwell."

In a case [15] arising under the 1913 Law the court, after

[15] Lynch v. Turrish, 247 U. S. 221. It does not seem that this consideration of the effect of Gray v. Darlington was strictly necessary to the decision in Lynch v. Turrish, as the Supreme Court might well have rested its decision on the first point relied on by Judge Sanborn in the Circuit Court of Appeals and on which point it completely vindicated that court, but the statement can scarcely be called dicta. In the case of Cleveland, C., C. and St. L. Ry. Co. v. U. S., 242 Fed. 18, affirmed 247 U. S. 195, the Circuit Court of Appeals said: "The precise point decided in Gray v. Darlington was that the accretion in value during the previous years was not income for the year in which the property was sold; but doubtless some of the language of the opinion would indicate that such accretions were not income even for the year in which they happened. In a case arising under the 1909 Law (Doyle v. Mitchell Brothers, 247 U. S. 179) Judge Pitney, who delivered the opinion quoted above from Hays v. Gauley Mountain Coal Co., said: "When we come to apply the Act to gains acquired through an increase in the value of capital assets acquired before and converted into money after the taking effect of the Act, questions of difficulty are encountered. The suggestion that the entire proceeds of the conversion should be still treated as the same capital, changed only in form and containing no element of income although including an increment of value, we reject at once as inconsistent with the general purpose of the Act. Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received 'from all sources.' * * * The formula that the entire receipts derived from a conversion of capital assets after deducting cost value must be treated as net income, so far as it is applied to a conversion of assets acquired before the Act took effect and so as to tax as income any increased value that accrued before that date, finds no support in either the letter or the spirit of the Act, and brings the former into incongruity with the latter. * * * Yet it is plain, we think,

quoting part of the opinion in Gray v. Darlington and stating that the case has not since been questioned or modified said in part:

"The Government feels the impediment of the case and attempts to confine its ruling to the exact letter of the Act of March 2, 1867, and thereby distinguish that act from the Act of 1913 and give to the latter something of retrospective effect. Opposed to this there is a presumption, resistless except against an intention imperatively clear. The Government, however, makes its view depend upon disputable differences between certain words of the two acts. It urges that the Act of 1913 makes the income taxed one 'arising or accruing' in the preceding calendar year, while the Act of 1867 makes the income one 'derived.' Granting that there is a shade of difference between the words, it cannot be granted that Congress made that shade a criterion of intention and committed the construction of its legislation to the disputes of purists. Besides, the contention of the Government does not reach the principle of Gray v. Darlington, which is that the gradual advance in the value of property during a series of years in no just sense can be ascribed to a particular year, not therefore, as 'arising or accruing,' to meet the challenge of the words, in the last one of the years, as the Government contends, and taxable as income for that year or when turned into cash. Indeed, the case decides that such advance in value is not income at all, but merely increase of capital and not subject to a tax as income."

Aside from the differences in the language of the Act of 1867 and the Revenue Act of 1918, the latter contains a provision expressly prescribing the method of comput-

that by the true intent and meaning of the Act the entire proceeds of a mere conversion of capital assets were not to be treated as income. Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities."

ing the gain derived from the sale of assets acquired before March 1, 1913. It was intimated in Gray v. Darlington that the rule as to merchants and traders would be different from the rule as to persons making isolated investments, this difference being due to the language of the act and predicated upon the general principle that merchants and traders have generally to take into account transactions originating in prior years in order to estimate their gains in any one year.

There seems to be no doubt that Congress intended under the Revenue Act of 1918 to tax profits from sales of property acquired prior to the taxable year, and the law makes no distinction between the investor and the merchant or trader. It is to be noted, however, that the 1918 Law imposes a tax "upon the net income of every individual" and "upon the net income of every corporation;" that gross income is defined to include "gains, profits and income *derived* from" specified sources, thus following to some extent the language of the income tax law of 1867, and that it does not tax "income received," which phrase in the 1909 Law led Mr. Justice Pitney to remark that that law "looked to the time of realization rather than to the period of accruement" of the income. Whether the 1918 Law intends to tax so-called "gains from the sale of capital assets" and whether the gradual increase in value of property over a series of years can be taxed under the Sixteenth Amendment are unsettled questions.

Want of Due Process of Law. The due process clause of the Fifth Amendment to the Federal Constitution is not a limitation upon the taxing power conferred upon Congress by the Constitution; in other words, the Constitution is not self-destructive and does not conflict with itself by conferring on the one hand a taxing power and taking the same away on the other by the limitations of the due process clause. To make a tax statute unconstitutional the seeming exercise of the taxing power of the act must be so arbitrary as to constrain to the conclusion that

it is not the exertion of taxation, but a confiscation of property, that is, a taking of the same in violation of the Fifth Amendment, or, what is equivalent thereto, is so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion.[16] In a late case arising under the 1913 Law [17] the Supreme Court enumerated a number of features of the 1913 Law which, it had been alleged, constituted a violation of the due process clause, and dismissed them with the statement that none in the remotest degree presented such questions. Among such objections were the following: (1) that the progressive rate and exemption features of the law were based on wealth alone and were wanting in due process of law; (2) that the duty cast upon corporations of collecting the tax at the source was wanting in due process of law, (a) because of the cost to which they were subjected, (b) because of the resulting discrimination between corporations indebted upon coupon and registered bonds and corporations not so indebted, (c) because of the further discrimination in the case of corporations so indebted which had assumed the payment of taxes on their bonds, (d) because of the further discrimination against corporate bondholders in the deprivation of the use of their money between the deduction and payment of the tax withheld, (e) because of the further discrimination against corporate bondholders in the fact that they might be obliged to pay the tax a second time if the corporation should fail after deduction, and (f) because of a further discrimination against bondholders in that they were not relieved of the duty of reporting bond income by payment at the source, the result being a double payment of the tax, labor and expense in obtaining a refund and deprivation of the use of their money in the meantime; (3) that the limitation on the amount of interest deductible by corporations is wanting

16 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.
17 Id.

in due process; (4) that the privilege granted to individuals of deducting dividends for purposes of normal tax was a discrimination against corporations; (5) that the deduction of $3,000 or $4,000 to those who pay the normal tax and not to those with incomes over $20,000 was wanting in due process; (6) that the discrimination between married and single people and between husbands and wives living together and husbands and wives not living together was wanting in due process; (7) that the law involved a discrimination and want of due process in favor of house owners living in their own houses who were not compelled to estimate the rental value against those who paid rent and were not allowed to deduct it and in favor of farmers who might deduct products of the farm used by them in sustaining their famiiles whereas family expenses might not, as a rule, be deducted. In another case [18] it was held there exists a substantial difference between the carrying on of business by corporations and the same business by a private firm or individual, and the 1909 Law was, therefore, not unconstitutional on the ground of arbitrary discrimination. In another case the court held that the fact that the tax was levied on the income of mining companies without making adequate allowance for depletion did not amount to the taking of property without due process of law.[19] In a case [20] arising under the law taxing foreign-built yachts it was stated by the court that the distinction between things foreign and things domestic, and their use, was apparent on the face of things and to tax them separately was not an arbitrary discrimination.

Uniformity. The Constitution exacts only a geographical uniformity of taxes and a lack of uniformity in other respects does not make the statute invalid.[21]

18 Flint v. Stone-Tracy Co., 220 U. S. 107.
19 Stanton v. Baltic Mining Co., 240 U. S. 103.
20 Billings v. U. S., 232 U. S. 261.
21 Knowlton v. Moore, 178 U. S. 41; Patton v. Brady, 184 U. S.

Exempting Certain Corporations from Tax. The provision of the Sixteenth Amendment authorizing a tax on incomes "from whatever source derived" does not require that the tax must be imposed upon all sources of income nor does it exclude the power to exempt certain classes of corporation.[22]

Retroactive Features. The right of Congress to impose a tax by a new statute, although the measure of the tax is governed by the income of the past year cannot be doubted; much less can it be doubted that Congress may impose a tax on income of the current year, though part of that year has elapsed when the statute is passed.[23] A statute imposing a tax upon all income of a previous year, although one tax on that income has already been paid, is valid.[24]

608; Flint v. Stone-Tracy Co., 220 U. S. 107; Billings v. U. S., 232 U. S. 261; Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

22 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

23 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1; Billings v. U. S., 232 U. S. 261.

24 Stockdale v. Insurance Companies, 20 Wall. 323.

CHAPTER 43

CONSTRUCTION OF THE LAW

It is beyond the scope of this chapter to discuss at great length the numerous rules of statutory construction. The following paragraphs will indicate briefly rules especially applicable to revenue statutes which may be of assistance in the interpretation of such ambiguities as are encountered in our present system of income, excess profits and other tax laws. Wherever possible the citation of authorities has been confined to cases arising under various revenue laws of the United States.

Although a statute may be construed contrary to its literal meaning when a literal construction would result in an absurdity, inconsistency, or in glaring inequality, and palpable injustice, where its language is susceptible of more reasonable, though perhaps less natural, construction which carries out its spirit rather than letter,[1] it is a well-settled general rule that a legislative act must be interpreted according to the intention of the legislature apparent upon its face.[2] Construction and interpretation have no place where the language of a statute is unambiguous and its meaning evident.[3] Arguments as to the expediency of a tax law or the possible economic mistake or wrong involved

1 Stratton's Independence v. Howbert, 231 U. S. 399; Knowlton v. Moore, 178 U. S. 41, 77; Treat v. White, 181 U. S. 264; Sesnon Co. v. U. S., 182 Fed. 573, writ of certiorari denied 220 U. S. 609.

2 Wilkinson v. Leland, 2 Pet. 627; U. S. v. Union Pacific R. R. Co., 91 U. S. 72.

3 U. S. v. Ninety-Nine Diamonds, 139 Fed. 961, writ of certiorari denied 201 U. S. 645.

in the tax imposed thereby [4] or the inequality thereof,[5] are beyond judicial cognizance.

To ascertain the intention of the legislature the first resort is to the grammatical sense and the natural, ordinary and familiar meaning of the words employed,[6] and it is particularly true that terms used in statutes describing objects of taxation should be construed according to the popular acceptation of the terms they employ rather than by refined or strained analogies.[7] The presumption is that language has been employed with sufficient precision to disclose the intention of the legislature and unless this presumption is overthrown, nothing remains but to enforce the statute as written.[8] If, however, it is apparent on the face of the statute, or from its context, that a term of common use and meaning is intended to bear some other signification, it may be interpreted accordingly.[9] Thus, the word "false" may be construed to mean either incorrect but in good faith [10] or incorrect with fraudulent intent.[11] Words having a fixed legal meaning are presumed to have been used in such sense.[12] Commercial and trade terms, which belong exclusively to the vocabulary of merchants and traders or which are shown to have a certain, uniform and general meaning in commerce and trade different from their ordinary meaning, will be interpreted

4 Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

5 Billings v. U. S., 232 U. S. 261.

6 Treat v. White, 181 U. S. 264; Schriefer v. Wood, 21 Fed. Cas. No. 12,481; U. S. v. Isham, 17 Wall. 496; U. S. v. Chesbrough, 176 Fed. 778; Seldon v. Equitable Trust Co., 8 Fed. Cas. No. 4,508, affirmed 94 U. S. 419.

7 Nix v. Hedden, 39 Fed. 109, affirmed 149 U. S. 304; De Ganay v. Lederer, 239 Fed. 568.

8 Mannington v. Hocking Valley R. R. Co., 183 Fed. 133.

9 U. S. v. Chesbrough, 176 Fed. 778.

10 National Bank of Commerce v. Allen, 223 Fed. 472; Eliot National Bank v. Gill, 218 Fed. 600.

11 U. S. v. Ninety-Nine Diamonds, 139 Fed. 961.

12 U. S. v. Fidelity Trust Co., 222 U. S. 158; Nat. Life & Accident Ins. Co. v. Craig, 251 Fed. 524.

accordingly.[13] Generally, a descriptive trade term used in the act will be given the special meaning attaching to it at the time the act was passed,[14] but in some cases a later and broader meaning may be adopted if warranted by commercial usage and the general language of the statute.[15]

General terms following special terms are, as a rule, limited in scope and meaning to the same general class as the special terms; in other words, the particular words are presumed to describe certain species and the general words to be used to include other species of the same genus.[16] But this is only a rule of construction to aid in arriving at the real legislative intent. It is not a cast-iron rule, overriding all other rules of construction, and it will never be applied to defeat the real purpose of the statute as gathered from its entire context. While the rule is aimed to preserve a meaning for the particular words, it should not be permitted to render meaningless the general words. Therefore, where the particular words exhaust the class, the general words must be construed as embracing something outside of that class. If the particular words exhaust the class, there is nothing *ejusdem generis* left, and in such case the general words must be given the meaning outside of the class indicated by the particular words, otherwise the meaning of the general words would be sacrificed to preserve the particular words and the rule would defeat its own purpose.[17]

The general rule of construction applicable to all statutes and written instruments that words should be given the meaning naturally attaching to them from their context

13 Maddock v. Magone, 152 U. S. 368; Sonn v. Magone, 159 U. S. 417.

14 Dennison Mfg. Co. v. U. S., 72 Fed. 258; Rossman v. Hedden, 145 U. S. 561; Hedden v. Richard, 149 U. S. 346; Mutual Benefit Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918.

15 Pickhardt v. Merritt, 132 U. S. 252; Newman v. Arthur, 109 U. S. 132.

16 U. S. v. 1,150½ pounds of Celluloid, 82 Fed. 627; Reiche v. Smythe, 13 Wall. 162; U. S. v. Weise, 28 Fed. Cas. No. 16,659.

17 U. S. v. Mescall, 215 U. S. 26.

and that a word of obscure meaning, taken by itself, may be construed by reference to associated words, is applicable to the construction of revenue laws.[18]

Effect should be given, if possible to the entire statute, and part should not be permitted to perish by construction. One part should not be allowed to defeat another part, if by any reasonable construction the two can stand together.[19] If the context of the statute is ambiguous, the title,[20] preamble,[21] and punctuation,[22] may be considered, but they are seldom the subject of special consideration by the legislature and are fallible and unreliable guides in ascertaining the intention of that body.

While the rule is that taxing statutes should be so construed as to prevent them from operating retroactively,[23] that is merely a principle of construction and the courts will not save a statute from producing a retroactive effect, if the intent that it should so operate is clear.[24]

Construction Which Will Be Constitutional. It is a well-established rule that when a statute admits of two interpretations, one of which presses it beyond constitutionality and the other of which brings it within constitutionality or avoids the question of constitutionality, the courts tend to adopt the latter interpretation.[25] The foundation of this rule, it is to be noted, is the possibility of

18 Marsching v. U. S., 113 Fed. 1006; U. S. v. Sixty-Five Terra Cotta Vases, 18 Fed. 508, 510; Patton v. U. S., 159 U. S. 500, 509; Adams v. Bancroft, 1 Fed. Cas. No. 44; Taber v. U. S., 23 Fed. Cas. No. 13,722.

19 U. S. v. Ninety-Nine Diamonds, 139 Fed. 961.

20 Knowlton v. Moore, 178 U. S. 41; Smythe v. Fiske, 23 Wall. 374; Church of Holy Trinity v. U. S., 143 U. S. 457; Hadden v. Collector, 5 Wall. 107; Cornell v. Coyne, 192 U. S. 418.

21 Price v. Forrest, 173 U. S. 410, 427.

22 U. S. v. Isham, 17 Wall. 496; U. S. v. Three Railroad Cars, 28 Fed. Cas. No. 16,513; Ford v. Delta Co., 164 U. S. 662.

23 Stockdale v. Insurance Co., 20 Wall, 323; Lynch v. Turrish, 247 U. S. 221.

24 Billings v. U. S., 232 U. S. 261.

25 Stratton's Independence v. Howbert, 231 U. S. 399; Singer Mfg. Co. v. McCollock, 24 Fed. 667.

two constructions, and the existence of grave doubt as to constitutionality. Where the doubt is not grave the courts will give the statute the most natural meaning resulting from its text, as otherwise the mere assertion that a statute is unconstitutional would tend to set aside the general rules of construction.[26]

Proceedings in Congress as Aid to Construction. Notwithstanding the well-established rule that the intent of the lawmakers is to be found in the statutes they pass, the courts, where the language of a statute is ambiguous and its meaning doubtful, should not shut their eyes to what can be learned of the history of the times and of the law, of the condition of the law at a particular time, the mischief or evil sought to be remedied, and other kindred things which would put them in the light that the lawmakers enjoyed and enable them to view the situation as it appeared to those who passed the act.[27] For such purposes, in interpreting ambiguous statutes, the formal reports of committees having in charge a pending legislative bill may, therefore, be referred to as bearing upon questions of legislative intent.[28] Courts take judicial notice of legislative journals and proceedings in Congress so far as they are admissible in aid of statutory construction.[29] But individual statements made in debate do not necessarily reflect the intent and understanding of the legislative body and are unreliable as an aid to construction, as many individual members may remain silent and may vote for a bill because in

[26] U. S. v. Bennett, 232 U. S. 299.

[27] U. S. v. Standard Oil Co., 221 U. S. 1; U. S. v. Trans-Missouri Freight Association, 166 U. S. 290, 318; Holy Trinity Church v. U. S., 143 U. S. 457, 463; Jennison v. Kirk, 98 U. S. 453; Northern Commercial Co. v. U. S., 217 Fed. 33; Ho Ah Kow v. Nunan, 5 Sawy. 552.

[28] Lapina v. Williams, 232 U. S. 78; Woodward v. DeGraffenried, 238 U. S. 284; Pennsylvania R. Co. v. International Coal Min. Co., 230 U. S. 184; McLean v. U. S., 226 U. S. 374; Shallus v. U. S., 162 Fed. 653; Mosle v. Bidwell, 130 Fed. 334.

[29] Connole v. Norfolk & Western Ry. Co., 216 Fed. 823; Wadsworth v. Boysen, 148 Fed. 771.

their judgment it has a wider or narrower scope than its author states.[30] Accordingly the courts may not, in interpreting a statute, recur to the motives of individual members of the legislative body nor to what they supposed the bill to mean.[31] Such individual statements may, however, be resorted to as a means of ascertaining the environment at the time of enactment of a particular law, that is, the history of the period when it was adopted.[32]

Effect of Rulings and Practice of Treasury Department. Great weight and due deference and respect is always given by the courts to the construction put upon a revenue statute by the Treasury Department.[33] This rule also applies to the construction of state statutes by the highest state authorities charged with the duty of administration, when the meaning of such state statutes is at issue in the Federal Courts.[34] Where the language of a statute is

30 Sweetser v. Emerson, 236 Fed. 161; Johnson v. U. S., 215 Fed. 679; U. S. v. Trans-Missouri Freight Association, 166 U. S. 290, 318; Mitchell v. Great Works Milling, etc. Co., 2 Story 653; MacKenzie v. Hare, 239 U. S. 299.

31 U. S. v. Union Pacific R. R. Co., 91 U. S. 72; Omaha & C. B. Street R. Co. v. Interstate Commerce Commission, 230 U. S. 324; Pennsylvania R. Co. v. International Coal Mining Co., 230 U. S. 184; Aldridge v. Williams, 3 How. 23.

32 Standard Oil Company v. U. S., 221 U. S. 1; Jennison v. Kirk, 98 U. S. 453, 459; Central Building, Loan & Savings Co. v. Bowland, 216 Fed. 526. It is difficult to reconcile the authorities on the question of the admissibility of individual statements in debate in interpreting a statute. There are cases such as Roberts v. Southern Pacific Co., 186 Fed. 934, affirmed 219 Fed. 1022, which consider such statements for more extended purposes than are permitted under the Standard Oil Co. case and the authorities heretofore cited, but they seem contrary to the weight of authority.

33 U. S. v. Cerecedo Hermanos y Compania, 209 U. S. 338; De Ganay v. Lederer, 239 Fed. 568; Smythe v. Fiske, 23 Wall. 374.

34 Insurance Co. of North America v. McCoach, 218 Fed. 905 reversed 224 Fed. 657, 661, writ of certiorari granted 241 U. S. 694, reversed 244 U. S. 585; See opinion of Circuit Court of Appeals. In reversing this court the Supreme Court conceded full effect to the administrative or executive construction followed, but held that it did not answer the decisive question involved.

dubious and open to different interpretations the construction of the Treasury Department is in the highest degree persuasive, if not controlling, in its effect upon the courts, and is not to be disregarded without the most cogent reasons if it has been followed for many years without any attempt on the part of Congress to change it and where there has been a long acquiescence in it, and especially if by it the rights of parties for many years have been determined and adjusted.[35] But the construction of the Treasury Department cannot repeal a statute; it can only be resorted to in aid of interpretation, and is not applicable to what has no need of interpretation. It is therefore inadmissible and immaterial where the language of the statute is clear and precise or where it will not bear the interpretation put upon it by the Department.[36]

Construction by Reference to Similar Statutes. As a general rule, where a statute is of doubtful meaning and susceptible on its face of two constructions,[37] the court may look into prior acts to determine its proper construction.[38] This rule has been repeatedly applied in the construction of the Revised Statutes of the United States.[39] It is particularly applicable to revenue legislation and absolutely necessary in the case of the legislation of Congress on this subject, for without it the revenue could not be collected and inextricable embarrassments and difficulties would constantly occur.[40] The revenue laws, though made up of independent enactments, are regarded as constituting

35 Robertson v. Downing, 127 U. S. 607.

36 Swift Company v. U. S., 105 U. S. 691; Merritt v. Cameron, 137 U. S. 542; U. S. v. Graham, 110 U. S. 219; U. S. v. Tanner, 147 U. S. 661.

37 Bate Refrigerating Co. v. Sulzberger, 157 U. S. 1.

38 Hamilton v. Rathbone, 175 U. S. 414; Connecticut General Life Ins. Co. v. Eaton, 218 Fed. 188.

39 Hamilton v. Rathbone, 175 U. S. 414; U. S. v. Hirsch, 100 U. S. 33; U. S. v. Bowen, 100 U. S. 508; U. S. v. Sixty-Five Terra Cotta Vases, 18 Fed. 508.

40 Stuart v. Maxwell, 16 How. 160.

practically one system,[41] and to ascertain the legislative intent courts not only search all the provisions of the particular revenue statute in question, but look beyond those to others *in pari materia,* or of a similar purport, which compose the system.[42] Any rule of construction, separating from this revenue system, and its component numerous and diverse enactments, each new act altering it, would be unsound and unsafe.[43] When Congress re-enacts without change a statute which has previously received a construction by the Federal Supreme Court, it will be deemed to have adopted such construction,[44] and an executive or departmental construction of an earlier act will also be sanctioned by subsequent re-enactments,[45] especially where the executive or departmental construction has been repeated and long continued [46] and where valuable property rights have been founded thereon.[47]

Similar Statutes in Other Jurisdiction. When a statute is adopted by another state or by Congress, the construction previously given to such a statute by the highest court of the state from which it is adopted presumably becomes an integral part of and is incorporated into the law so adopted.[48] This is but a narrower application of the general principle that the language of an act is used, and so is to be interpreted, according to its legal significance at the time the act is passed.[49] The rule applies only to the construction followed in the state from which the statute is originally adopted and not to that followed in the state from

41 In re. Southern Pacific Co. 82 Fed. 311, affirmed 87 Fed. 863.

42 U. S. v. Collier, 25 Fed. Cas. No. 14,833.

43 Saxonville Mills v. Russell, 116 U. S. 21.

44 Latimer v. U. S., 223 U. S. 501.

45 U. S. v. Ceredo Hermanos y Compania, 209 U. S. 338; U. S. v. Falk & Bro., 204 U. S., 143, 152.

46 U. S. v. Baruch, 223 U. S. 191.

47 Swigart v. Baker, 229 U. S. 187.

48 Mustard v. Elwood, 223 Fed. 225; Robinson v. Belt, 187 U. S. 41; McDonald v. Hovey, 110 U. S. 619; Interstate Commerce Commission v. D. L. & W. R. Co., 220 U. S. 235.

49 Commercial Travellers Ass'n v. Rodway, 235 Fed. 370, 374.

which the statute is immediately taken,[50] and applies also primarily to decisions in force at the time of adoption. The courts may, however, treat subsequent decisions with respect.[51] But the rule that the courts of one state will deem the interpretative decisions of another state a part of a statute adopted from that state is not an absolute one, to be followed under all circumstances. It will not be followed where the construction urged to be adopted is contrary to the obvious meaning of the statute to be construed[52] or would make the statute unconstitutional in the state of adoption.[53]

Strict or Liberal Construction. The authorities upon the question of whether a taxing statute should be strictly or liberally construed, or whether it should be construed according to some medium between these two extremes, are in some confusion and no broad general rule can be safely stated. Excluding the construction of tax exemptions, which will be treated hereafter, three general lines of authority can be traced. One line of cases[54] holds that, as stated by the court in a leading case:[55]

"In the first place, it is, as I conceive, a general rule in the interpretation of all statutes, levying taxes or duties upon subjects or citizens, not to extend their provisions,

50 Coulam v. Doull, 133 U. S. 216.

51 Cathcart v. Robinson, 5 Pet. 264.

52 Whitney v. Fox, 166 U. S. 637.

53 In re. Swearinger, 23 Fed. Cas. No. 13,683.

54 U. S. v. Wigglesworth, 2 Story 369, 28 Fed. Cas. No. 16,690; U. S. v. Isham, 17 Wall. 504; U. S. v. Watts, 28 Fed. Cas. No. 16,653; Equitable Trust Co. v. Seldon, 8 Fed. Cas. No. 4,507. The court said in Powers v. Barney, 5 Blatch. 202, "Duties are never imposed on the citizen upon vague or doubtful interpretations." There are early cases holding to the contrary such as U. S. v. Olney, 27 Fed. Cas. No. 15,918, where a statute imposing a license fee for lottery dealers was being construed and the court said: "A revenue law is not to be strictly construed, but rather the contrary, so as to attain the ends for which it was enacted." See Twenty-Eight Cases, 2 Ben. 63; Rankin v. Hoyt, 4 How. 327; Smythe v. Fiske, 23 Wall. 374, 380.

55 U. S. v. Wigglesworth, 2 Story 369, 28 Fed. Cas. No. 16,690.

by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters, not specifically pointed out, although standing upon a close analogy. In every case, therefore, of doubt, such statutes are construed most strongly against the government, and in favor of the subjects or citizens, because burdens are not be imposed, nor presumed to be imposed, beyond what the statutes expressly and clearly import. Revenue statutes are in no just sense either remedial laws or laws founded upon any permanent public policy, and, therefore, are not to be liberally construed.''

Since this decision it has been repeatedly held by the United States Supreme Court and the inferior federal courts that the provisions of a tariff act should be liberally construed in favor of the importer, and that in cases of fair doubt as to the construction of a provision in such acts the courts should resolve the doubt in favor of the importer and that in such cases the intention of Congress to impose a higher duty should be expressed in clear and unambiguous language.[56] And the same rule has been applied in the construction of other revenue laws,[57] in-

[56] Benziger v. U. S., 192 U. S. 38; American Net & Twine Co. v. Worthington, 141 U. S. 468; Shallus v. U. S., 162 Fed. 653; U. S. v. Tiffany, 160 Fed. 408; Hayes v. U. S., 150 Fed. 63; Hempstead v. Thomas, 122 Fed. 538; U. S. v. Merck & Co., 91 Fed. 639, affirmed 97 Fed. 989; Rice v. U. S. 53 Fed. 910. It has been said that the rule which gives the importer the benefit of a doubt is limited to cases where it relieves all importers of all articles whatsoever of the class concerned; that it probably has no practical use except in cases of extraordinary doubt; that it has a more appropriate application when the question is one of any tax at all; and that the federal reports are full of suits where the courts have not hesitated to perform the duty of determining mere questions of classification where it was admitted some duty was to be imposed, in favor of a higher rate, under circumstances of great difficulty. U. S. v. Wetherell, 65 Fed. 987.

[57] Eidman v. Martinez, 184 U. S. 578; Treat v. White, 181 U. S. 264; Gill v. Bartlett, 224 Fed. 927; Rockefeller v. O'Brien, 224 Fed. 541, affirmed 239 Fed. 127; Disston v. McClain, 147 Fed. 114; Wright v. Michigan Central R. Co., 130 Fed. 843; McNally v. Field, 119 Fed. 445; Treat v. Tolman, 113 Fed. 892.

cluding the 1909 law[58] and 1913 law.[59] In a comparatively late case construing the war revenue act of June 13, 1898, imposing a special excise tax on sugar the Supreme Court, adopting the language of the dissenting opinion in the Court below, held that where the construction of a tax law is doubtful, the doubt is to be resolved in favor of those upon whom the tax is sought to be laid.[60] And in a very recent case[61] arising under the 1913 law in the Supreme Court, the rule quoted above was restated as an established rule of construction.

Three recent cases in the lower federal courts have also stated generally with particular reference to the 1909 Corporation Excise Tax Law that revenue laws should be strictly construed against the government,[62] and it has been held that this rule applies especially where they impose burdens of a special or unusual character.[63]

A second line of cases holds that revenue laws are not to be strictly construed in favor of the subject and against the state, but still with reasonable fairness to the citizen. It is stated in U. S. v. Distilled Spirits:[64]

"In construing a severe statute, declaring a heavy forfeiture, (and, according to one construction claimed, for small offences,) it is just to say, that those who are called upon to conduct their business affairs in view of all its provisions, ought to be fairly apprised of its requirements,

58 Parkview Building & Loan Ass'n v. Herold, 203 Fed. 876, affirmed 210 Fed. 577.

59 Haiku Sugar Co. v. Johnstone, 249 Fed. 103; U. S. v. Coulby, 251 Fed. 982 (both decided since the Gould case, cited hereafter).

60 Spreckels Sugar Ref. Co. v. McClain, 192 U. S. 397.

61 Gould v. Gould, 245 U. S. 151. It is to be noted that in this case the court used almost identically the language of Judge Story in the old Wigglesworth case; also that Mr. Justice McReynolds makes no reference to the Stowell case (cited hereafter).

62 Mutual Benefit Ins. Co. v. Herold, 198 Fed. 199, affirmed 201 Fed. 918; Anderson v. Morris & E. R. Co., 216 Fed. 83; Penn. Steel Co. v. N. Y. City Co., 198 Fed. 774, affirmed 231 U. S. 144.

63 Lynch v. Union Trust Co., 164 Fed. 161.

64 U. S. v. Distilled Spirits, 27 Fed. Cas. No. 15,960; 10 Blatch. 428.

and of its penalties, of whatever kind. They are bound to know the law, but lawmakers owe to them the duty to make the law intelligible; and those whose business it is to construe or expound a law which is of doubtful or double meaning, should not incline to the harshest possible meaning, when it is obvious that those to whom it is to be applied may well have been led to trust in another which is less severe, but equally satisfying in its terms. This is not saying that laws of the kind in question are to be strictly construed in favor of the subject and against the state but, only, that they should be construed with reasonable fairness to the citizen."[65]

A third line of cases announces a rule much more favorable to the government. As stated in the early cases, penalties annexed to violations of the general revenue laws do not make them penal in the sense which requires them to be construed strictly.[66] This statement was amplified and further explained in the leading case of U. S. v. Stowell,[67]

65 The U. S. v. Distilled Spirits case was a penalty case arising under the Internal Revenue Laws and the rule announced in it seems to have been modified by the Stowell case (cited hereafter).

66 U. S. v. Barrels of Spirits, 2 Abb. (U. S.) 305, 314; U. S. v. Cases of Cloth, Crabbe 356; Taylor v. U. S., 3 How. 197; Cliquot's Champagne, 3 Wall. 114, 145; U. S. v. Hodson, 10 Wall. 395, 406.

67 U. S. v. Stowell, 133 U. S. 1. It is to be doubted whether in this case or the case of U. S. v. Hodson, 10 Wall. 395, 406, the Supreme Court meant to overrule Judge Story in the Wigglesworth case. In both cases the court refers as authority to the case of Taylor v. U. S., 3 How. 197, 210, which was decided by Judge Story without mentioning his immediately previous opinion in the Wigglesworth case. It seems highly improbable Judge Story meant to overrule himself in the Taylor case but rather that he had a distinction in mind between revenue laws generally and statutes to prevent fraud upon the revenue. At the time of the Wigglesworth decision Judge Story had also decided the case of U. S. v. Breed, 24 Fed. Cas. No. 14,638 in which he said in part, "Revenue and duty acts are not in the sense of the law penal acts; and are not therefore to be construed strictly. Nor are they, on the other hand, acts in furtherance of private rights and liberty, or remedial; and therefore to be construed with extraordinary liberality. They are to be construed according to the true import and meaning of their terms; and

which was an information on forfeiture of distilling machinery, on the theory that statutes to prevent frauds on the revenue are considered as enacted for the public good and to suppress a public wrong, and therefore, although they impose penalties or forfeitures, are not to be construed. like penal laws generally, strictly in favor of the defendant; but they are to be fairly and reasonably construed, so as to carry out the intention of the Legislature. This case has been cited and followed constantly [68] notably in a recent

when the legislative intention is ascertained, that, and that only, is to be our guide in interpreting them. We are not to strain them to reach cases not within their terms, even if we might conjecture, that public policy might have reached those cases; nor, on the other hand, are we to restrain their terms, so as to exclude cases clearly within them, simply because public policy might possibly dictate such an exclusion.'' See also Rankin v. Hoyt, 4 How. 332; Smythe v. Fiske, 23 Wall. 374, 380. In the last mentioned case the question was the amount of duty on silk ties.

[68] In the following cases involving the construction of revenue laws with particular reference to penal forfeitures and criminal provisions for violations: U. S. v. Two Barrels of Whiskey, 96 Fed. 479; U. S. v. 246½ Pounds of Tobacco, 103 Fed. 791; 581 Diamonds v. U. S., 119 Fed. 556, 561; U. S. v. Cole, 134 Fed. 697; U. S. v. Gallant, 177 Fed. 281; U. S. v. Thompson, 189 Fed. 838. In the following cases with particular reference to bonds to protect the government against violations: U. S. v. Nat. Surety Co., 122 Fed. 904, 909; U. S. v. Zemel, 137 Fed. 989; U. S. v. U. S. Fidelity & G. Co., 144 Fed. 866. In the following cases as authority for the liberal construction of miscellaneous laws: Roberts v. Pacific Nav. Co., 104 Fed. 577; U. S. v. St. Louis S. W. Ry., 189 Fed. 954, 962; U. S. v. Ramsey, 197 Fed. 144, 147; U. S. v. Brown, 224 Fed. 135; Johnson v. Southern Pacific Co., 196 U. S. 1. See also Sesnon Co. v. U. S., 182 Fed. 573, writ of certiorari denied 220 U. S. 609.

Before the Stowell decision there were cases adopting a strict construction even of statutes to prevent frauds in the revenue. See U. S. v. 84 Boxes of Sugar, 7 Pet. 453 (expressly disapproved in the Stowell case); Sixty Pipes Brandy, 10 Wheat. 424; U. S. v. A Lot Silk Umbrellas, 12 Fed. 412 (citing U. S. v. 84 Boxes Sugar); U. S. v. Ten Cases Shawls, 28 Fed. Cas. No. 16,448. One case adopting a strict construction of the statute to prevent frauds on the revenue since the Stowell case is U. S. v. 1,150½ Pounds Celluloid, 82 Fed. 634 (citing U. S. v. 84 Boxes of Sugar, supra, and not citing the Stowell case); Sixty Pipes Brandy, 10 Wheat. 424; U. S. v. A Lot theory of ''*ejusdem generis.*''

case [69] in the Supreme Court construing certain forfeiture provisions of the Internal Revenue Laws, and its authority has never been expressly questioned or restricted.

The latest statement of the United States Supreme Court referred to above [70] makes it clear that revenue laws, as to the persons and things to be taxed will be strictly construed in the sense that their provisions will not be extended beyond the clear import of the language used or their operations enlarged so as to embrace matters not specifically pointed out, and that doubt as to such matters will be resolved more strongly against the government and in favor of the citizen. In respect to their penal provisions, however, both those working forfeitures and those imposing penalties or imprisonment, rather than in respect to the question of whom and what the statute taxes, it may still be that revenue laws will be considered as remedial in their character and so liberally construed so as to carry out the purpose of their enactment.[71]

Exemption from Taxation. This paragraph deals only with the construction of the language of a tax law which exempts. The rules of construction applicable to language which lays the tax have already been discussed.[72] The distinction between the rules of construction applicable to language laying the tax and language exempting from tax is important, for, as has been observed, in respect to the

69 U. S. v. Graf Distilling Co., 208 U. S. 198.

70 See Gould v. Gould, 245 U. S. 151.

71 This distinction will not reconcile all the cases. For instance, the early cases of Smythe v. Fiske (See Note 67) and Rankin v. Hoyt, (See Note 67), the later cases of Hunter v. Corning & Co., 86 Fed. 913; Lowe v. Farbwerke-Hoechst Co., 240 Fed. 671; De Ganay v. Lederer, 239 Fed. 568 (now on the docket of the United States Supreme Court), clearly contemplate the application of the of liberal construction with respect to subjects and objects of taxation. On the other hand, the case of U. S. v. Distilled Spirits (See Note 64) contemplates the application of the rule of liberal construction as announced in the Stowell case in a modified form; that is, neither liberally nor strictly but "with reasonable fairness to the citizen."

72 See paragraph headed "Strict or Liberal Construction."

former doubts will be resolved most strongly against the government and in favor of the citizen, while in respect to the latter, as will appear, a most strict construction in favor of the government is called for.[73]

The taxing power is of vital importance and is essential to the existence of government; the whole community is interested in maintaining it undiminished.[74] Exemptions from taxation are regarded as in derogation of sovereignty[75] and it is abundantly established that the taxing power should never be presumed to be relinquished unless the intention to do so be declared in clear and unambiguous terms,[76] which will admit of no other construction[77] and which are too plain to be mistaken.[78]

The existence of a well founded or rational doubt is equivalent to a denial of a claim to exemption.[79] No claim can be sustained unless within the express letter or the necessary scope of the exempting clause,[80] construed *strictissimi juris;*[81] an exemption will not be inserted in a statute by construction.[82] But this salutary rule requiring a strict construction of exemptions must not be misunderstood. It is not a substitute for all other rules and does not mean that whenever a controversy is or can be raised as to the meaning of a taxing statute, such ambiguity occurs as immediately and inevitably to determine its interpretation. The proper office of the rule is to help solve ambiguities, not to compel an immediate surrender to them—to be an

[73] Herold v. Parkview Building & Loan Ass'n, 210 Fed. 577.

[74] Providence Bank v. Billings, 4 Pet. 514; Christ Church v. Philadelphia County, 24 How. 300.

[75] Yazoo & Miss. Valley R. Co. v. Thomas, 132 U. S. 174.

[76] Tennessee v. Whitworth, 117 U. S. 139; Keokuk & W. R. Co. v. Missouri, 152 U. S. 301.

[77] Southwestern R. R. Co. v. Wright, 116 U. S. 231.

[78] Chicago, etc., R. R. Co. v. Missouri, 120 U. S. 569.

[79] Phoenix Fire Ins. Co. v. Tennessee, 161 U. S. 174; Wright v. Georgia R., etc., Co., 216 U. S. 420.

[80] Ford v. Delta & Pine Land Co., 164 U. S. 662.

[81] Vicksburg S. & P. R. Co. v. Dennis, 116 U. S. 665.

[82] Providence Bank v. Billings, 4 Pet. 514; U. S. v. Coulby, 251 Fed. 982.

element in decision, and effective, perhaps, when all other tests of meaning have been employed which experience has afforded and which it is the duty of courts to consider.[83] And so courts, in construing the exempting clauses of taxing statutes, are not required to hunt for an escape from an exemption, but will, where the intent to exempt clearly appears, give effect to such intent without evasion.[84]

Rule of Construction Followed by the Treasury Department. As a general rule the construction by the Treasury Department is such as is most favorable to the enforcement of the revenue laws and no liberal interpretation in favor of the individual is indulged in.[85] In announcing this rule the Attorney General cited the cases of Taylor v. U. S.;[86] Cliquot's Champagne,[87] U. S. v. Hodson,[88] and Smythe v. Fiske,[89] and which, as has been stated, construed both statutes to prevent frauds on the revenue and the provisions of taking statutes laying the tax. The Attorney General does not appear to have taken account of the distinction which has been pointed out between these two kinds of provisions, so far as their construction is concerned. As a matter of practice the Treasury Department cannot, of course, assume the balanced judicial attitude of the courts in interpretation of doubtful points, as its function is to administer the law and its duty, primarily, to collect revenue. However, in some cases the Department has gone to great length in making liberal interpretation favorable to the taxpayer.[90]

83 Citizens Bank v. Parker, 192 U. S. 73.
84 Buchanan v. Knoxville & O. R. Co., 71 Fed. 324.
85 18 Op. Atty. Gen. 246.
86 3 How. 197, 210.
87 3 Wall. 114.
88 10 Wall. 395.
89 23 Wall. 374.
90 Compare, for instance, the Excess Profits Tax Law of 1917 with the Regulations No. 41.

CHAPTER 44

TAX ON UNDISTRIBUTED INCOME OF CORPORATIONS

The provisions which imposed this tax were contained in the 1916 Law as amended.[1] No similar tax is imposed by the Revenue Act of 1918. The purpose of the tax was to counteract the tendency of corporations to permit their earnings to accumulate as surplus, which action, although not taken with the intent of evading the surtaxes, would, nevertheless, operate to reduce the surtaxes paid by individual stockholders. Under this provision of the law a corporation could retain any part or all of its earnings for the year 1917, provided it was willing to pay a tax of 10% upon such portion thereof as was not (a) actually invested and employed in the business, (b) retained for employment in the reasonable requirements of the business or (c) invested in obligations of the United States issued after September 1, 1917. If the earnings of the corporation were accumulated with a fraudulent purpose or intent of preventing the imposition of the surtaxes on the stockholders, such stockholders could be taxed under the 1916 Law as though the earnings had been distributed.[2] The tax on undistributed income of corporations was not intended to take the place of this provision, but was intended to operate in cases where the annual net income was retained beyond the reasonable requirements of the business of the corporation and yet not with fraudulent

[1] Revenue Act of 1916, § 10 (b), added by Revenue Act of 1917.

[2] Revenue Act of 1916, § 3, corresponding to Revenue Act of 1918, § 220.

intent to avoid the imposition of the surtaxes on the stockholders of the corporation.

Tax Repealed by Present Law. The provision of the 1916 Law imposing the tax on undistributed income of corporations is repealed by the 1918 Law, except to the extent that it "shall remain in force for the assessment and collection of all taxes which have accrued thereunder." It is also expressly provided that "except as otherwise provided in this Act, no taxes shall be collected under Title I of the Revenue Act of 1916 as amended * * * in respect to any period after December 31, 1917."[3] It seems clear that no tax can be imposed with respect to any income received in 1918. If the phrase "any period after December 31, 1917," has reference to the point of time six months after the close of the taxable year, at which time the status of the income for the purpose of this tax was to be determined, then the repealer amounts to practically a complete nullification of the tax, since in the great majority of cases that point of time fell after December 31, 1917. A reasonable view, however, seems to be that this tax will be held to apply to all incomes earned in 1917, and in the case of corporations whose fiscal years ended in 1918, the undistributed income should be apportioned as was provided in the case of corporations whose fiscal years ended in 1917. As to the 15% tax imposed in cases where the Secretary of the Treasury should find that any "amount so retained at any time for employment in the business is not so employed or is not reasonably required in the business" it seems that such tax does not accrue until the finding of the Secretary has been made, and if the tax did not accrue before the date of repeal of the law no tax can be assessed under the law.

Corporations Subject to the Tax. The law provided that the tax should apply to "every corporation, joint-stock company or association or insurance company."[4]

[3] Revenue Act of 1918, § 1400.
[4] See T. D. 2736.

The tax, undoubtedly, applied to every domestic corporation and to such foreign corporations as had their principal office or place of business in the United States, that is, the class of corporations, somewhat indefinitely referred to in the 1916 Law as "resident corporations." It was ruled in the case of an English corporation whose total net income from sources within the United States was less than half of the entire income from all sources, and whose sole American stockholder held less than one-fifth of one per cent., the tax applied to the undistributed earnings of the taxable year derived from sources within the United States.[5] It was also ruled that corporations with fiscal years ending in 1917 were subject to the tax on that proportion of their net income allocated to the year 1917.[6] Corporations or organizations exempt from the income tax were exempt from the undistributed profits tax.[7]

FOREIGN CORPORATIONS. A foreign corporation was held not to be relieved from this tax because it remitted to its home office within six months after the close of its taxable year the full amount of net income derived from business transactions from sources within the United States, such remittances not being a distribution of net earnings of the taxable year within the meaning of the law. Any part of the net income of a foreign corporation derived from sources within the United States which remained undistributed six months after the close of the taxable year, even though remitted to the home office, were considered taxable unless it was disposed of as specified in the law. Any disposition of the net earnings derived

5 Telegram from Treasury Department dated July 6, 1918; I. T. S. 1918, ¶ 3591.

6 T. D. 2736. An earlier informal ruling (Telegram from Treasury Department dated July 5, 1918; I. T. S. 1918, ¶ 3590), seemed to indicate that only corporations whose fiscal years ended within six months prior to October 3, 1917, were taxable, and that such corporations were taxable on their entire net income for the fiscal year without apportionment.

7 T. D. 2736.

from sources within the United States which could not be exactly allocated, might be determined on a proportionate basis, that is, on the same proportion as the income from within the United States bore to the entire income of the corporation from the entire business transacted by it, both within and without the United States.[8]

Undistributed Net Income. The undistributed net income referred to in this provision of the law was the income for the taxable year, either the calendar year or the fiscal year accordingly as the corporation reported on the basis of the calendar or a fiscal year. The first year for which the tax was imposed was the calendar year 1917 or, if the corporation had elected to report its net income for the fiscal year, the fiscal year ending in 1917; in the latter case, however, the tax was held to apply only to the proportion of the taxable undistributed net income for such fiscal year as the period between January 1, 1917, and the end of the fiscal year was to the whole of such fiscal year. For example, if the fiscal year of a corporation ended on June 30, 1917, and its taxable undistributed income for that fiscal year was $50,000 only one-half thereof or $25,000 was held to be taxable, since only one-half of the fiscal year was in the calendar year 1917. This provision of the law had no reference to the income, profits or surplus earned or accumulated by the corporation prior to January 1, 1917, whether or not such income, profits or surplus was employed in the business. The fact that surplus accumulated prior to January 1, 1917, might not have been employed in the business, or retained for the reasonable requirements of the business, might, however, bear upon the taxability of the income for the current year, since it was difficult to earmark the current income and employ it in business while surplus previously accrued was not so employed. Within the

[8] Letter from Treasury Department dated July 23, 1918; I. T. S. 1918, ¶ 3615. The application of these rulings to foreign corporations which had no office or place of business in the United States was doubtful.

meaning of this provision of the law the net income, whether represented by liquid assets or otherwise, for the current year was distributed only when paid to the stockholders as dividends.[9] Another provision of the 1916 Law, respecting dividends,[10] deemed such dividends to have been paid out of the most recently accumulated undivided profits or surplus. The burden was upon the corporation seeking to establish a distribution in the current year of profits of the preceding taxable year to show that all the earnings of the current year had been first distributed. In determining the source of earnings from which a particular distribution was made, a corporation was, however, permitted to treat the earnings of the current year as reduced by payments for income and excess-profits taxes, or, if keeping its accounts upon an accrued basis, by proper reserves for such taxes, although such payments or reserves were not deductible in computing the income of the corporation for income and excess-profits taxes.[11] The difference between the amount of net income shown in its return of annual net income and the amount thereof distributed by the corporation at any time before the expiration of six months after the end of its fiscal or calendar year, were held to constitute the undistributed net income which this provision of the law taxed. From such amount of undistributed net income the following items might be deducted: (a) the amount of any income taxes imposed by authority of the United States, paid by the corporation within the taxable year from income of that year; (b) that portion of such undistributed net income which was actually invested and employed in the business or; (c) retained for employment in the reasonable requirements of the business, or (d) invested in obligations of the United States issued after September 1. 1917. If the taxable year began on January 1, 1917, the remainder was the amount upon which the tax was assessed.

9 T. D. 2736.
10 Revenue Act of 1916, § 31 (b) added by Revenue Act of 1917.
11 T. D. 2736; T. D. 2678; T. D. 2659.

If the taxable year began before January 1, 1917, the proportion of such remainder which the period between January 1, 1917, and the end of such taxable year bore to the whole of such taxable year was the amount upon which the tax was assessed.[12]

TIME OF DETERMINING UNDISTRIBUTED INCOME SUBJECT TO TAX. The amount of undistributed income subject to the 10% tax was to be determined as of the date six months after the end of the taxable year. Changes in the amount of such undistributed income after such date were held not to change the amount subject to the tax. The Commissioner of Internal Revenue had no authority to extend the time within which the undistributed net income could be disposed of in the manner specified in the statute as avoiding the payment of the 10% tax either in the case of a taxable year ending before October 3, 1917, or of any other taxable year.[13] In other words, the application of the 10% tax was fixed according to the true financial condition of the corporation as of six months after the close of its taxable year. If it then had undistributed net income of the previous year not invested or retained as specifically indicated in the statute, the tax applied. It seems a corporation did not become subject to the 10% additional tax by reason of any change in its investments or financial situation after the date of the expiration of such six months, but might become subject to the 15% tax.[14]

INCOME TAXES PAID WITHIN THE YEAR. For the purpose of determining the net income subject to the income tax a corporation was not permitted to deduct the amount of the Federal income taxes paid within the year, but such amounts were deductible for the purpose of this tax pro-

12 T. D. 2736; telegram from Treasury Department dated July 26, 1918; I. T. S. 1918, ¶ 3614; letter from Treasury Department dated July 23, 1918; I. T. S. 1918, ¶ 3615.

13 T. D. 2736.

14 Letter from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3438. See the paragraph on Rate of Tax, p. 699.

vided the payment was made from the earnings of the taxable year. Excess-profits taxes paid during the year were not deductible for the purpose of this tax, since the net income subject to this tax was that determined for the purpose of the income tax imposed by the 1916 Law upon corporations, which was the income remaining after the Commissioner had deducted the amount of excess-profits taxes assessed against the corporation in the same year. As an illustration, if a corporation had a net income of $100,000 for the year 1917 and the war excess-profits tax assessed against it, on such income, was $20,-000, the income tax for 1917 was assessed upon the remainder of the net income after deducting the amount of $20,000, that is, on $80,000. From the sum of $80,000 the corporation might further deduct the amount of federal income taxes assessed against it for the year 1916, and paid by it in the year 1917 (not the income tax assessed against it for the year 1917, since such tax was not paid until the year 1918). From the net amount so obtained, it might deduct the amount of undistributed net income employed or invested as indicated in the following paragraphs.[15]

NET INCOME ACTUALLY INVESTED AND EMPLOYED IN THE BUSINESS. The amount of undistributed net income for the taxable year which was actually invested or employed in the business was not taxable. Under this head

[15] Letter from Treasury Department dated July 12, 1918; I. T. S. 1918, ¶ 3598. In many of its rulings, and in the form, the Treasury Department proceeded on the incorrect premise that the "net income" subject to this tax was the net income before deducting the excess profits tax assessed for the same year, whereas the law explicitly stated the "net income" was that "determined for the purposes of the tax imposed" by § 10 (a) of the 1916 Law, i. e., the income tax, for which purpose the excess profits tax assessed for the same year was first deducted. The law contemplated that the excess profits tax assessed for the same year should be applied against the income of that year in ascertaining the "undistributed income" and not that the taxpayer should have an option of applying or not applying it.

was included only such earnings as had been actually and permanently invested or employed within the taxable year or within six months after the end of such year. Undistributed income was held to be used or employed in the business (a) if invested in increased inventories or additions to plant reasonably required by the business; (b) if used for the payment of income and excess-profits taxes for the taxable year, provided the amounts so paid were designated upon the books of the corporation as made from the income of such taxable year; (c) if used to make good an impairment of capital when such income was by law required to be so used; or (d) if used to retire the whole or any part of the capital stock of the corporation. Reserves set up for the last mentioned purpose were neither invested and employed in the business, nor retained for employment in the reasonable requirements of the business. In the case of a banking institution the business of which is to receive and loan money, using capital, surplus and deposits for this purpose, undistributed income actually represented by loans was invested and employed in the business.[16] A corporation unable to show by tracing into particular assets or into the decrease of particular liabilities the employment of undistributed net income in the business was permitted to claim a benefit of what might be shown by a balance sheet before the date of the expiration of six months after the taxable year, or by a comparative balance sheet. Thus, if the balance sheet before the date of the expiration of the six month period showed that the entire surplus of undistributed profits of a corporation were represented by assets pertaining directly to the business, such as plant, equipment, inventory and accounts receivable, with only such amount represented by cash and by saleable securities as was reasonably necessary for working capital, or other established business requirements, the inference was warranted that the undistributed net income for the taxable year had

16 T. D. 2736.

been employed either for increasing the assets needed for the business, or for the reduction of business liabilities. Corporations unable to establish through tracing into particular assets or into the decrease of particular liabilities the use of undistributed net income for employment in the business were permitted to submit a comparative balance sheet showing in reasonable detail the assets and liabilities of the corporation as at the opening and the close of the taxable year, and as at the close of the six month period. Resort was to be made to the balance sheet to show the employment in the past of all undistributed net income of the taxable year, or its retention for the reasonable requirements of the business, as indicated in the next paragraph. It was also held that the net income for the six months after the taxable year was necessary to be taken into account and it was necessary to show that the undistributed net income of the taxable year, as well as the undistributed net income of the six month period was so employed or retained.[17]

NET INCOME RETAINED FOR EMPLOYMENT IN THE REASONABLE REQUIREMENTS OF THE BUSINESS. This deduction differs materially from the one referred to in the preceding paragraph. It was not required that the undistributed net income should be actually used or employed in the busniess before the expiration of six months after the end of the taxable year, but it was sufficient if such income had been retained for employment in the reasonable requirements of the business. Undistributed income was held to be retained for employment in the reasonable requirements of the business if (a) it was retained to a reasonable amount to make good an impairment of capital when such income was by law required to be so used; (b) it was placed in accordance with contract requirements to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation; or (c) it was retained for working capital required by the

[17] T. D. 2763.

business. In the case of a banking institution the business of which is to receive and loan money, using capital, surplus and deposits for this purpose, such reasonable amounts of undistributed net income as were retained for future loans were not subject to tax.[18] The earnings of a corporation used to purchase preferred stock for cancellation were held to be retained for employment in the reasonable requirements of the business and therefore not taxable.[19] It was held that a corporation operating under a long term lease soon to expire, which created a reserve out of income for new machinery and new plant to provide against being forced to vacate, and which invested the reserve in securities, was subject to the tax on the amount so reserved unless immediately upon ascertaining that it was not forced to vacate, it invested such amount in obligations of the United States issued after September 1, 1917, or invested it or retained it for employment in the requirements of its business, or distributed the same as dividends.[20]

"THE BUSINESS" OF A CORPORATION. "The business" of a corporation was not limited to the business which the corporation had previously carried on but included any line of business which the corporation might legitimately undertake. When one corporation owned the stock of another corporation in the same or a related line of business and in effect operated the other corporation, the business of the other corporation falling within the general scope of the powers of the first, that business might be in effect although not in legal form the business of the first corporation. Income of the first corporation might be put into the second through the purchase of stock or otherwise and might, if the subsidiary relationship was established, constitute employment of the income in its own business. For such employment to fall within the

18 T. D. 2736.

19 T. D. 2570.

20 Telegram from Treasury Department dated July 8, 1918; I. T. S. 1918, ¶ 3594.

exception it was essential for the corporation to show the same facts with reference to the actual utilization of the funds so employed, or their retention for its reasonable requirements which it was necessary for the corporation to show with reference to funds employed or retained directly by it. Investment by a corporation of income in securities of another corporation was not, without more, to be regarded as employment of the income in "the business." The business of one corporation might not be regarded as including the business of another, within the meaning of that exception, unless the other corporation was a mere instrumentality of the first; to establish this it was ordinarily essential to show that the first corporation owned all of the stock of the second.[21]

NET INCOME INVESTED IN OBLIGATIONS OF THE UNITED STATES. In order to avoid any question as to whether or not the undistributed net income for the year had been retained for the reasonable requirements of the business, such income might be invested in obligations of the United States issued after September 1, 1917. Any amount so invested might be deducted, for the purpose of this tax, whether or not it was necessary, or merely advisable, to retain such amount for employment in the business at some future time. Such part of the undistributed net income as might be invested in the first issue of Liberty Loan bonds (which were not issued after September 1, 1917) was subject to the tax unless, by such investment, the amount was employed in the business or unless the amount was retained for employment in the reasonable requirements of the business. The restrictions as to the distribution of earnings of previous taxable years resulting from the presumption that all current distributions were from current earnings did not apply to the use of earnings for investments by corporations. There was no limitation or restriction as to the source from which earnings used for this purpose might be taken. Amounts

21 T. D. 2736.

invested in obligations of the United States issued after September 1, 1917, might thus be treated as made from such earnings as the corporation might designate.[22] When a corporation made any distribution of dividends, however, the distribution was required to be treated as made from the most recent profits or surplus, regardless of any previous designation of any portion of such earnings for investment purposes. In other words the designation of an investment in obligations of the United States issued after September 1, 1917, might serve to prevent the application of this tax to the amount so invested, but it did not permit the amount of net income for the taxable year so invested to be disregarded in determining the profits or surplus from which any dividends might be distributed.[23]

Rate of Tax. The undistributed profits tax was at two different rates—10% and 15%. On the amount of net income remaining undistributed six months after the end of each calendar or fiscal year, after making the several reductions described above, a tax of 10% was levied. The law provided that if the Secretary ascertained and found that any portion of the amount retained for employment in the business was not so employed or was not reasonably required in the business, a tax of 15% was to be imposed.[24] Under this provision of the law it was held that the liability of undistributed net income to the 10% tax depended upon the manner in which it was invested on the date six months after the end of the taxable year, but that the status of the income was not lost by the investment, but persisted for the possible application of the 15% tax. Amounts of undistributed net income not subject to the 10% tax because of employment in the business, retention for such employment or investment in certain obligations of the United States, were held to become subject to the 15% tax if retained after such investment, employment or retention for employment in the reasonable require-

[22] T. D. 2736; T. D. 2700; T. D. 2570.
[23] T. D. 2763.
[24] Revenue Act of 1916, § 10 (b) added by Revenue Act of 1917.

ments of the business had ceased.[25] Thus if a corporation which invested a portion of its undistributed net income of the previous year in obligations of the United States issued after September 1, 1917, sold such obligations after the expiration of the six months, it was held that the proceeds of the sale became subject to the 15% tax unless such earnings were immediately distributed or actually invested or employed in the business, or retained for employment in the reasonable requirements of the business.[26] This last ruling, however, seems to extend the tax beyond the express purport of the law, which seemed to impose this 15% tax only with respect to "any portion of such amount so retained at any time for employment in the business." There was nothing in the law which required the corporation to retain such bonds so long as they were owned on a date six months after the close of the taxable year.

Returns. Every corporation required by the 1916 Law as amended to make a return of its annual net income, and which had a taxable net income for the preceding taxable year, was required to make a return of the amount of such net income received during such taxable year remaining undistributed six months after the end of such taxable year. The return was sworn to by the president, vice-president or other principal officer, and by the treasurer or assistant treasurer of the corporation, and was made to the Collector of Internal Revenue of the district in which its return of annual net income was required to be filed.

[25] T. D. 2736. The tax of 15% is in the nature of a penalty tax. It should be noted that this provision practically made the Secretary of the Treasury judge as to when the earnings were employed in the business, or what the reasonable requirements of the business might be. The provision was intended as a means of deterring officers of corporations from making too liberal allowances for the reasonable requirements of the business. In effect, it imposed a penalty of 50% of the amount of the tax for understatement of the taxable undistributed earnings.

[26] Letter from Treasury Department dated May 23, 1918; I. T. S. 1918, ¶ 3438.

Such return was required to be made within sixty days after the expiration of six months after the end of such taxable year, except that any corporation which would otherwise be required to make a return on or before a date earlier than August 1, 1918, might make such return on or before August 1, 1918.[27]

Penalties. If the tax assessed on undistributed net income was not paid within ten days after the date of notice and demand therefor it was the duty of the collector to make collection with a penalty of 5%, additional upon the amount thereof and interest at the rate of one per cent a month. In case of any failure to file a return within the time prescribed by law 50% of the amount of the tax was added thereto, except that when a return was voluntarily and without notice from the collector filed after such time, and it was shown that the failure to file it was due to reasonable cause and not to wilful neglect, no such addition was made to the tax. In case a false or fraudulent return was wilfully made, 100% of the amount of the tax was added thereto. Corporations, officers thereof, and other individuals required to make, render, sign or verify returns of corporations were subject to the specific penalties provided by law for refusal or neglect to make such returns and for making false or fraudulent returns.[28]

[27] T. D. 2736. Form No. 1112 was used in making the return.
[28] T. D. 2736.

CHAPTER 45

WAR-PROFITS AND EXCESS-PROFITS TAX

The Act of March 3, 1917, was the first excess-profits tax law enacted in this country.[1] That statute imposed a tax of 8% on all net income in excess of the sum of $5,000 plus 8% of the actual capital invested.[2] It applied only to corporations and partnerships. A small amount of tax was collected under that statute from corporations whose fiscal years ended in the succeeding months but any amounts so collected were credited or refunded to the taxpayers. On October 3, 1917, the second excess-profits tax law was enacted, which imposed a tax on the net income of individuals, partnerships and corporations, derived from any business or trade. This statute (referred to in this Chapter as the 1917 Law) was retroactive to January 1, 1917, and covered the period during which the Act of March 3, 1917, had been in effect. The rates of the 1917 Law as applied to corporations having invested capital were 20% of that part of the net income which exceeded the excess-profits deduction and did not exceed 15% of the invested capital; 25% on that part of the net income which exceeded 15% of the invested capital and did not exceed 20% of the invested capital; 35% of the net income which exceeded 20% of the invested capital and did not exceed 25% of the invested capital; 45% on that part of the net in-

1 39 Stats. at Large 1000.

2 The statute defined the term "actual capital invested" to mean (1) actual cash paid in; (2) the actual cash value at the time of payment of assets other than cash paid in, and (3) paid in or earned surplus and undivided profits used or employed in the business; but to exclude money or other property borrowed.

come which exceeded 25% of the invested capital and did not exceed 33% of the invested capital; and 60% on that part of the net income which exceeded 33% of the invested capital. In the case of a trade or business which had no invested capital or not more than a nominal capital, the excess-profits tax was 8% on the entire net income in excess of $3,000 in the case of a domestic corporation and $6,000 in the case of a domestic partnership, or a citizen or resident of the United States. In the case of a foreign corporation or partnership or a non-resident alien this rate was imposed upon the entire net income without deduction. The Act of February 24, 1919, (referred to in this Chapter as the Revenue Act of 1918, the 1918 Law, or the present law) imposes a tax on income received during the year 1918 in lieu of the tax imposed by the 1917 Law. In view of the increased individual normal and surtax rates upon the income of individuals and partnerships, which in most cases will make the income taxes paid by such individuals as high as the income and excess or war-profits taxes paid by corporations engaged in similar business, and in view of the difficulty in administering an excess-profits tax applicable to individuals, it was decided by Congress that the war-profits and excess-profits taxes should apply to corporations only.[3] It was also recognized that there exists a class of corporations which require very little or no invested capital and whose income is derived mainly from the personal services of the stockholders. Examples of such corporations are corporations composed of engineers or accountants, who might as readily have formed partnerships to carry on the business. Such corporations are called "personal-service corporations" and are treated as though they were partnerships. No excess-profits tax is imposed upon their net income but the stockholders of the personal-service corporation are taxable upon the entire net income of the year whether or not such income is distributed in the form of dividends.

[3] Report of the Committee on Ways and Means on the Revenue Bill of 1918, September 3, 1918.

The tax imposed by the present law combines two general principles of taxation: (a) that of a war-profits tax, which is usually considered to be a tax on the excess of profits made during the years of the war period over the normal profits of the years prior to the war and (b) an excess-profits tax, which is usually considered to be a tax upon the profits in excess of a specified percentage representing an approximate normal return on the invested capital. The law, however, does not adhere to a clear distinction between war-profits and excess-profits since the war-profits tax combines a feature of the excess-profits tax in that a minimum deduction of 10% of the invested capital is allowed regardless of the earnings of the corporation during the prewar period. Under the excess-profits method of computing the tax the rate is graduated, 30% being applied to that part of the net income which exceeds the excess-profits deduction and does not exceed 20% of the invested capital and 65% being applied to that part of the income which exceeds 20% of the invested capital. The war-profits tax rate is a single rate of 80% in excess of the war-profits credit. It has been estimated that under the 1917 Law the average amount of excess-profits tax was about 30% of the net income of corporations for the year 1917. It is conjectured that the war-profits and excess-profits tax will absorb on an average about 45% of the 1918 income. In addition the income tax will absorb 12% of the remainder so that it is probably safe to predict that about one-half of the net income of corporations for the year 1918 will be paid to the Federal Government by way of war-profits, excess-profits and income taxes.

Individuals. Individuals are not subject to the war-profits and excess-profits tax. Since individuals were not allowed to file returns for their fiscal years under the 1917 Law no individual has paid a tax on 1918 income under the 1917 Law and, therefore, the 1918 Law contains no provision with respect to individuals such as the provision with respect to partnerships for redetermining the tax due on 1917 income.

Partnerships. Partnerships are not subject to the war-profits or excess-profits tax under the present law.

PARTNERSHIPS WHICH HAVE PAID A TAX ON 1918 INCOME. If a partnership has made a return under the 1917 Law for a fiscal year ending in 1918, and paid the tax, a certain proportion thereof will be refunded. This amount is to be determined by taking the same proportion of the tax so paid as the proportion of the fiscal year in 1917 is to the entire fiscal year. Thus, if one-fourth of the fiscal year fell in 1917 and three-fourths in 1918, three-fourths of the tax which has been paid will be refunded immediately as a tax erroneously or illegally collected.[4] If a return has been filed but the tax has not yet been paid, claim for abatement of the amount applicable to 1918 income should be filed simultaneously with the payment of the amount applicable to 1917 income.

Personal-Service Corporations. Personal-service corporations are not subject to the war-profits and excess-profits tax but are taxed as partnerships.[5] Such corporations are described in a preceding chapter.[6]

[4] Revenue Act of 1918, § 335 (c). See Chapter 38 for procedure in claiming refund or abatement.

[5] Revenue Act of 1918, §§ 300 and 200.

[6] Chapter 10. The 1917 Law imposed a tax of 8% upon a trade or business having no invested capital or not more than a nominal capital. This provision is omitted from the present law but in its place are the provisions respecting personal service corporations. Under the 1917 Law it was held that business concerns which rendered professional or personal services would not be taxed on the basis of invested capital merely because of the capital if the employment of such capital was necessitated by delay and irregularity in the receipt of fees, etc., or if such capital was wholly or mainly used as a fund from which to advance salaries, wages, etc., or to provide office furniture, accommodations and equipment. Agents and brokers were held to be taxable at the graduated rates with reference to invested capital if they employed a substantial amount of capital whether to lend to principals or to carry goods on their own account but otherwise were taxable only at the flat rate of 8%. (Regulations 41, Articles 72 and 73.)

PERSONAL-SERVICE CORPORATIONS WHICH HAVE PAID A TAX ON 1918 INCOME. If any corporation which under the present law is held to be a personal-service corporation has filed a return and paid a tax under the 1917 Law for a fiscal year ending in 1918, a portion of the tax so paid will be refunded. The amount to be refunded is determined by the proportion of the fiscal year in 1918 to the entire fiscal year. Thus, if five months of the fiscal year fell in the calendar year 1918, five-twelfths of the tax paid on the income of the full fiscal year will be refunded.[7] If the tax has been paid, the corporation should file a claim for refund. If the tax has been assessed but not yet paid, a claim for abatement of the amount applicable to 1918 income should be filed simultaneously with the payment of the amount applicable to the 1917 income.[8]

Corporations Engaged Partly in Personal-Service Business. Where a part of the net income of a corporation is derived from a part of its business in which the employment of capital is necessary and a part (constituting not less than 30% of its total net income) is derived from a part of its business which, if it constituted the sole trade or business, would bring the corporation within the class of personal-service corporations, the tax upon that part of the net income which is derived from the use of capital is separately computed and the tax upon the second part of the net income is the same percentage thereof as the tax computed upon the first part of the net income is of such first part.[9]

APPORTIONMENT OF INVESTED CAPITAL AND NET INCOME. For the purpose of determining whether or not a corporation partly partaking of the nature of a personal-service corporation is within the scope of the statute and also for the purpose of establishing the basis for the computation of the tax, the corporation shall apportion or allocate its

7 Revenue Act of 1918, § 336 (c).

8 See Chapter 38 for procedure as to refund or abatement.

9 Revenue Act of 1918, § 303.

invested capital between each trade or business or branch thereof as nearly as may be in accordance with the actual facts, and shall submit with its return an explanatory statement setting forth the manner in which the apportionment of the invested capital employed in the production of each part of its net income has been determined. There must be assigned to any personal-service trade or business or branch thereof an amount of invested capital at least as great as that which would ordinarily be employed by a personal-service corporation of similar size and standing for the payment of salaries and office expenses, maintenance of library and equipment, credit advances to clients, etc.[10]

COMPUTATION OF TAX UPON NET INCOME. (1) The tax upon the non-personal service part of the net income is computed upon the basis of (a) such part of the entire average net income for the prewar period as was derived from the same trade or business or branch thereof; (b) such part of the entire average invested capital for the prewar period as was employed in the production of the part of the net income for that period determined under (a); (c) such part of the entire invested capital for the taxable year as has been employed in the production of the net income upon which the tax is being computed; and (d) the same proportion of the specific exemption and credits as the proportion which the part of the net income upon which the tax is being computed is of the entire net income. If the corporation was in existence during the prewar period, but did not conduct this trade or business or branch thereof during that period, the war-profits credit is 10% of the invested capital for the taxable year. (2) The tax upon the personal-service part of the net income is the same percentage thereof as the tax computed under (1) is of the non-personal-service part of the net income. The tax under this paragraph shall in no case be less than

10 Reg. 45, Art. 741. For the method of determining the portion of the net income from each trade or business or branch thereof see p. 710.

20 per cent. of the personal-service part of the entire net income, unless the tax upon the entire net income if computed in the ordinary way would be less than 20 per cent. of such entire net income. In that event, and in any case in which the amount of the total tax as computed under this article is the same as or greater than the tax as computed in the ordinary way, the tax shall be computed as if all the income was derived from the use of capital.[11]

Corporations. All corporations except those expressly exempt by the statute are subject to this tax. The term "corporations" includes associations, joint-stock companies and insurance companies.[12] A corporation dissolved prior to the time the present law went into effect, but which was in receipt of income during 1918 or 1919 will be held subject to the tax imposed by the present law for the reason that the law is retroactive and in force and effect as of the first day of January, 1918.[13]

EXEMPT CORPORATIONS. Corporations exempt from the income tax are also exempt for the purpose of this tax.[14] In addition any corporation whose net income for the taxable year is less than $3,000 is exempt from this tax. If the taxable period is less than twelve months the corporation is exempt from the tax if its net income for the period is less than the same proportion of $3,000 as the number of months in the period is of twelve months, any part of a month being counted as a month.[15]

CORPORATIONS DERIVING INCOME FROM GOVERNMENT CONTRACTS. Special provisions apply to corporations deriving income from Government contracts. A government contract is defined in the law to be (a) a contract made with the United States, or with any department, bureau,

11 Reg. 45, Art. 742. See illustration p. 777.

12 See Chapter 12 for discussion of the definition of the term "corporations."

13 See Letter from Treasury Department dated November 17, 1917. W. T. S. 1918, ¶ 614.

14 See Chapter 15 for list of exempt corporations under the income-tax law.

15 Revenue Act of 1918, § 304; Reg. 45, Art. 751.

officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a sub-contract made with a contractor performing such a contract if the products or services to be furnished under the sub-contract are for the benefit of the United States. The term "Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive" when applied to a contract of the kind referred to in clause (a) of this paragraph, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law.[16] For the taxable year 1919 and thereafter every corporation which derives in such year a net income of more than $10,000 from any Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, will be required to pay the tax at the 1918 rates on the net income attributable to such Government contracts, such tax to be computed according to the rule stated in a subsequent paragraph.[17] Corporations which have no prewar period and which were in receipt of 50% or more of gross income during the taxable year from gains, profits, commissions or other income derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, will be limited to a war-profits credit of 10% on the invested capital of the taxable year,[18] although other corporations which had no prewar period may claim a higher deduction if the earnings of similar corporations during the prewar period were more than 10%. Corporations 50% or more of whose gross income for the taxable year consists of gains, profits, commissions or other income derived on

16 Id. § 1.

17 Id. § 301 (c). See p. 710 and p. 776.

18 Id. § 311 (d).

a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, will not be allowed to avail themselves of the remedial provision which will permit other corporations to be assessed on the basis of the tax paid by representative corporations.[19] It is to be noted that the first two provisions refer to Government contracts generally while the third provision is limited to cost-plus contracts. Corporations organized after August 1, 1914, and not a successor to a then existing business, 50% or more of whose gross income consists of gains, profits, commissions or other income derived from government contracts made between April 6, 1917, and November 11, 1918, both dates inclusive cannot be considered as affiliated with any other corporation for the purpose of making consolidated returns.[20]

GOLD-MINING CORPORATIONS. In the case of a corporation engaged in the mining of gold, that portion of its net income derived from the mining of gold is exempt from this tax. The tax on the remaining portion of its net income is computed in the following manner: The tax is first computed on the entire net income but only such proportion thereof as the proportion of net income derived from sources other than gold mining bears to the entire net income, is taken to be the amount due.[21]

Allocation of Net Income to Particular Source. In the case of corporations deriving income from Government contracts, or from mining or from personal-service trade or business, and in any other cases where it is necessary to determine the portion of the net income derived from or attributable to a particular source, the corporation shall allocate to the gross income derived from such source, and to the gross income derived from each other source, the expenses, losses and other deductions properly appertaining thereto, and shall apply any general expenses, losses and deductions (which can not properly be otherwise appor-

19 Id. § 327 (d). See p. 763.
20 Id. § 240 (a). See p. 768.
21 Id. § 304. See illustration p. 778.

tioned) ratably to the gross income from all sources. The gross income derived from a particular source, less the deductions properly appertaining thereto and less its proportion of any general deductions, shall be the net income derived from such source. The corporation shall submit with its return a statement fully explaining the manner in which such expenses, losses and deductions were allocated or distributed.[22]

Taxable Year. The term "taxable year" means the calendar year or the fiscal year ending during such calendar year, upon the basis of which the net income is computed for the purpose of the income tax. The first taxable year is the calendar year 1918 or any fiscal year ending during the calendar year 1918.[23]

Fiscal Year. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December.[24] If a corporation keeps its accounts on the basis of a fiscal year the law requires that it reports its income on that basis, and not either on that basis or on the basis of the calendar year as was the rule formerly.[25]

FISCAL YEAR ENDING IN 1918. If a corporation made a return for a fiscal year ending in 1918 the tax shall be computed on the entire net income for the fiscal year under the provisions of the 1917 Law and such proportion of that amount shall be taken as the proportion of the fiscal year falling within the calendar year 1917 is to the whole fiscal year. Similarly the tax shall be computed on the entire net income for the fiscal year under the provisions of the 1918 Law, and such proportion of that amount shall be taken as the proportion of the fiscal year in 1918 is to the whole fiscal year.[26] Any amount heretofore or hereafter paid on account of the tax imposed for such fiscal

22 Reg. 45, Art. 715.
23 Revenue Act of 1918, §§ 300 and 200.
24 Id. § 300 and § 200.
25 Id. § 232, § 212 (b) and § 200.
26 Id. § 335. See illustration p. 779.

year by the Revenue Act of 1917 is to be credited toward the payment of the tax as computed above, and if the amount so paid exceeds the amount of tax so computed the excess is to be credited or refunded to the corporation.[27]

FISCAL YEAR ENDING IN 1919. If a corporation makes a return for a fiscal year ending in 1919 the tax for such fiscal year is determined as follows: What the tax would be for the entire fiscal year computed at the 1918 rates is first determined and such proportion thereof as the part of the fiscal year falling in 1918 bears to the entire fiscal year is assessed as the tax. Similarly the 1919 rates are applied to the entire net income for the fiscal year and such portion taken as the proportion of the fiscal year in 1919 bears to the full fiscal year.[28] The sum of the two amounts thus ascertained is the tax for the fiscal year.

Prewar Period. The term "prewar period" means the calendar years 1911, 1912 and 1913, or, if a corporation was not in existence during the whole of such period, then as many of such years during the whole of which the corporation was in existence. Thus, if a corporation was in existence during the year 1913, that year becomes its prewar period, but if in existence only a part of the year 1913 it is deemed to have no prewar period and becomes taxable under the provisions applying to corporations formed after the prewar period.[29]

[27] Corporations whose fiscal years ended in 1918 may have filed a return and paid the tax for the full fiscal year under the provisions of the Revenue Act of 1917. Where such is the case the tax is to be recomputed in the manner indicated in this paragraph and from the amount so found to be due should be deducted the amount of excess-profits tax heretofore paid on the basis of a return for the full fiscal year. It follows that the income tax for the same period must also be recomputed according to the rule in § 205 (a) of the 1918 Law after having deducted the taxes on excess profits computed according to the rule here stated.

[28] Revenue Act of 1918, § 335. See illustration p. 779.

[29] Id. § 310. Under the 1917 Law the earnings of the prewar period determined the amount of the excess-profits deduction, between the limits of 7% and 9% of the invested capital. Under the

Statement of the Tax. The tax imposed by this title of the law is in lieu of the tax imposed by Title II of the Revenue Act of 1917, but in addition to the other taxes imposed by the Revenue Act of 1918. The tax is imposed upon the net income of every corporation whether or not derived from a business or trade or from investment or otherwise.[30] Briefly stated, the excess-profits tax is computed on the entire net income of the taxable year after deducting the excess-profits credit, at the rates specified in the Act; and the war-profits tax is computed on the entire net income in excess of the war-profits credit at the rate specified in the Act, and whichever of the two taxes is the greater is the amount assessed. The rates of tax, net income, invested capital, excess-profits credit and war-profits credit are more fully discussed in the following paragraphs.

Rates of Tax for 1918. The rates are stated in the form of three brackets as follows:[31] First bracket, 30% of the amount of net income in excess of the excess-profits credit and not in excess of 20% of the invested capital. If the excess-profits credit equals or exceeds 20% of the invested capital, no tax is imposed under this bracket.[32] The second bracket provides a rate of 65% of the amount of net income in excess of 20% of the invested capital. If, however, the excess-profits credit exceeds 20% of the invested capital, this rate is applied only to the amount of net income in excess of such excess-profits credit. The third bracket provides that there shall be added to the tax computed under the first and second brackets the sum, if any, by which 80% of the amount of net income in ex-

present law no reference is made to the pre-war period in ascertaining the excess-profits credit, since that credit is 8% of the invested capital regardless of the pre-war earnings. But the pre-war earnings and pre-war invested capital are used in computing the war-profits credit.

30 Id. § 301.

31 Id. § 301 (a).

32 Id. § 301 (d). See illustration No. 3, p. 775.

cess of the *war-profits credit* exceeds the amount of tax computed under the first and second brackets. As a practical matter, if 80% of the amount of net income in excess of the war-profits credit is greater than the tax computed under the first and second brackets, the 80% tax becomes the tax due from the corporation and the computation under the first and second brackets may be disregarded.[33]

Rates of Tax for 1919. In the case of all corporations other than those referred to in the following paragraph, the rates for 1919 computed under the first bracket as above indicated shall be 20% instead of 30% and under the second bracket shall be 40% instead of 60%. No tax will be imposed under the third bracket.[34]

CORPORATIONS DERIVING INCOME FROM GOVERNMENT CONTRACTS. For the taxable year 1919, and each taxable year thereafter, the rates to be applied to corporations which derive in such year a net income of more than $10,000 from any government contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, are determined as follows: (1) the tax shall be computed at the 1918 rates on the entire net income of the corporation, in the computation of which the excess-profits credit and war-profits credit applicable to the taxable year shall be used, and (2) the tax shall also be computed on the entire net income of the taxable year at the 1919 rates. Such portion of the tax computed under (1) as the net income attributable to such government contract or contracts bears to the entire net income and such portion of

[33] This device of adding the excess amount of the war-profits tax over the excess-profits tax to such excess-profits tax was invented by the Senate to overcome the objection to the provision in the bill as originally drafted, which expressly provided for an alternative excess-profits or war-profits tax, the larger of the two being the amount assessed. The change made by the Senate did not in substance change the tax and it is still a tax computed by two alternative methods, the one productive of the greater amount of revenue being applied to the taxpayer. See illustrations p. 774, et seq.

[34] Revenue Act of 1918, § 301 (b). See illustration p. 774.

the tax computed under (2) as the part of net income not attributable to such government contract or contracts bears to the entire income shall be the amount paid by the corporation.[35] The method of computing the tax is illustrated below.[36]

Maximum Limit of Tax. In no case shall the tax imposed on the net income for the taxable year 1918 be more than 30% of the amount of net income in excess of \$3,000 and not in excess of \$20,000, plus 80% of the amount of net income in excess of \$20,000. In no case shall the tax imposed on the net income for the taxable year 1919, or subsequent years, be more than 20% of the amount of net income in excess of \$3,000 and not in excess of \$20,000, plus 40% of the amount of net income in excess of \$20,000. In the case of corporations deriving more than \$10,000 of net income from government contracts in 1919 or subsequent years these respective limitations shall apply to the respective amounts of tax computed under the 1918 and 1919 rates. Thus, on that part of the net income derived from government contracts the maximum limit of 30% and 80% shall apply while to that not derived from government contracts the maximum limit of 20% and 40% shall apply. This limit is not intended to increase the tax but to reduce it in cases where the tax calculated in the manner prescribed by Section 301 of the law is greater than the maximum computed according to this paragraph.[37] The limitation will generally operate only in the case of corporations with very small invested capital.

SALE OF MINES, OIL OR GAS WELLS. In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the war-profits and excess-profits tax attributable to such sale shall

[35] Id. § 301 (c). See p. 710 for rule as to allocation of income.
[36] See p. 776.
[37] Id. § 302. See p. 781.

not exceed 20% of the selling price of such property or interest.[38] To determine the application of this provision to a particular case the corporation should compute the war-profits and excess-profits tax in the ordinary way upon its net income, including its net income from any such sale. The proportion of the total tax indicated by the ratio which the taxpayer's net income from the sale of the property, computed as prescribed in article 715,[38a] bears to its total net income is the portion of the tax attributable to such sale, and if it exceeds 20 per cent. of the selling price of the property such portion of the tax shall be reduced to that amount.[38b]

Invested Capital.[38c] "Invested capital" is the value of the capital and surplus of the taxpayer determined in accordance with rules laid down in the statute. It does not mean the par value of the issued and outstanding stock or the value of the capital stock as fixed by the Treasury Department for the purpose of the capital stock tax. It does not mean the book value of the assets. Generally speaking, it means the amount of cash or the cash value of the property contributed to the corporation by the stockholders and the amount of earnings of the corporation which have been left in the business. Money or other property borrowed is not invested capital. The cash value of the property contributed by the stockholders to the corporation may in some cases exceed the value allowed by the law for purpose of invested capital since the restrictive rules of the statute limit the invested capital representing intangible property, as is more fully stated below. Further, capital may be contributed to the business in a form which allows it to be considered as invested capital at its full value (cash, for instance) but may lose some of its value for the purpose of invested capital by being invested in stocks of other corporations (the dividends of which are not included in net income) or by being invested in state,

[38] Id. § 337.
[38a] See p. 710.
[38b] Reg. 45, Art. 971. See p. 779 for illustration.
[38c] As to Affiliated Corporations see p. 768.

municipal or other bonds of that character (the interest on which is exempt under the income tax law). In this respect the law makes an exception of bonds or other obligations of the United States, which may be included in invested capital although the interest therefrom may in some cases be excluded from net income.[39] Surplus and undivided profits are recognized as part of the invested capital, if they represent assets actually existing and owned by the corporation. The surplus and undivided profits accounts may be reduced below the amount at which they are carried on the books if full recognition has not been given by the corporation to expenses incurred and losses sustained from the original organization down to the taxable year, including among such expenses and losses a reasonable allowance for depletion, depreciation or obsolescence of property originally acquired for cash or stock or in any other manner. The value of the assets of the company are required in all instances to be taken as at the time of acquisition, although they may have increased in value since that date. If values have been marked up on the books of the corporation a deduction must be made in respect of such appreciation so taken up. Full effect must also be given to any liquidation of the original capital at any time prior to or during the taxable year.[40] In the case of a reorganization, consolidation or change of ownership of a trade or business after January 1, 1911, the invested capital of the predecessor for the prewar period is deemed to be the invested capital for such period of the new organization now engaged in the business.[41] In the case of a reorganization, consolidation or change of ownership of a trade or business, or change of ownership of property after March 3, 1917 (if 50% or more

[39] The purpose of permitting bonds of the United States to be included as invested capital, although the interest may in whole or in part be excluded from net income is to provide an incentive to invest in and hold such bonds.

[40] See Reg. 41, Art. 42.

[41] See Page 754.

of the interest or control remains in the same persons) the assets so transferred will not be allowed a higher valuation in determining invested capital than under the previous ownership. If the previous owner was not a corporation, the value of the assets in the hands of the present owner shall be taken at the cost to the previous owner.[42] The law contemplates that the invested capital shall be the average amount employed for a full year and if a corporation makes a return for a period less than twelve months the invested capital must be prorated accordingly. Thus although a corporation actually had an invested capital of $100,000 and was in existence for six months of the year 1918, for the purpose of this tax its invested capital would be considered as being only $50,000.[43] With respect to the value to be placed upon the several classes of assets of a corporation, such assets are divided into three classes: (1) cash paid in; (2) tangible property paid in and (3) intangible property paid in. Regardless of the character of the asset when paid in a further distinction is made with respect to the character of the asset during the taxable year. For this purpose the assets are divided into two classes, (1) admissible assets and (2) inadmissible assets. The several classes and the adjustments required to be made with respect to each and to all as a whole are stated in the following paragraphs.

Cash Paid In. The amount of cash paid in in exchange for stock is invested capital and remains such whether used for the purpose of acquiring tangible or intangible

[42] See p. 745 for more complete statement.

[43] See letter from Treasury Department dated March 20, 1918. W. T. S. 1918, ¶ 912. This amounts to an assumption that if the corporation had been in business for the full year it would have earned twice the amount it did during the six months period. If it can be shown that by the very nature of its business no more income would have been earned had the corporation been in existence for the full year, it would seem that the case is one for remedial action under Section 327. See p. 763.

property.[44] Thus if the stockholders have actually and in good faith paid in cash for stock of the corporation such cash may be used to purchase good will, patents, copyrights, trademarks or tradebrands, and the assets so acquired may be considered as invested capital to the extent of their cost. It is only when such assets are acquired in exchange for stock that the restrictive provisions of the statute apply. If however the cash is used to acquire inadmissible assets the invested capital will thereby be reduced since inadmissible assets reduce invested capital.

Bonus Stock. Capital stock issued as a bonus in connection with the sale of a corporation's bonds may not be included in invested capital unless the corporation proves to the satisfaction of the Commissioner that such stock bonus enabled the corporation to secure a higher price for the bonds than it could otherwise have secured. Wherever this fact is established such stock shall be included in computing invested capital to the extent of the difference between the selling price of the bonds and the price at which they could have been sold if issued without such stock bonus. The excess of the face value of such bonds over the price at which they could have been sold if issued without the stock bonus is deemed discount and is subject to amortization.[44a]

Tangible Property Paid In. When stock or shares have been issued for tangible property the actual cash value of the tangible property at the time it is paid in becomes invested capital. If the actual cash value of such tangible property exceeds the par value of the stock issued therefor,[45] the excess over the par value may be treated as paid-in surplus, provided it is shown to the satisfaction of the Commissioner that the value of the property

[44] Revenue Act of 1918, § 326 (a).

[44a] Reg. 45, Art. 832.

[45] The par value of stock or shares, in the case of stock or shares issued at a nominal value or having no par value, is deemed to be the fair market value as of the date such stock or shares are issued (Revenue Act of 1918, § 325).

was clearly and substantially in excess of the par value of the stock. Evidence offered to support a claim for a paid-in surplus must be as of the date of the payment, and may consist among other things of (a) an appraisal of the property by disinterested authorities made on or about the date of the transaction; (b) certification of the assessed value in the case of real estate; and (c) proof of a market price in excess of the par value of the stock or shares. The additional value allowed in any case is confined to the value definitely known or accurately ascertainable at the time of the payment. No claim will be allowed for a paid-in surplus in a case in which the additional value has been developed or ascertained subsequently to the date on which the property was paid in to the corporation, or in respect of property which the stockholders or their agents on or shortly before the date of such payment acquired at a bargain price, as for instance, at a receiver's sale. Generally, allowable claims under this article will arise out of transactions in which there has been no substantial change of beneficial interest in the property paid in to the corporation, and in all cases the proof of value must be clear and explicit.[46] The Commis-

[46] Reg. 45, Art. 836. In 1917 the rule was: Where it can be shown by evidence satisfactory to the Commissioner that tangible property has been conveyed to a corporation or partnership by gift or at a value, accurately ascertainable or definitely known as at the date of conveyance, clearly and substantially in excess of the cash or the par value of the stock or shares paid therefor, then the amount of the excess shall be deemed to be paid-in surplus. The adopted value shall not cover mineral deposits or other properties discovered or developed after the date of conveyance, but shall be confined to the value accurately ascertainable or definitely known at that time. Evidence tending to support a claim for a paid-in surplus under these circumstances must be as of the date of conveyance, and may consist, among other things, of (1) an appraisal of the property by disinterested authorities, (2) the assessed value in the case of real estate, and (3) the market price in excess of the par value of the stock or shares. (Reg. 41, Art. 63.) This ruling was supported by the language of the 1917 Law (§ 207a) which permitted the inclusion of "the actual cash value of tangible property paid in * * * at the time of such payment."

sioner is required to keep a record of all cases in which tangible property is included in invested capital at a value in excess of the par value of the stock issued therefor, containing the name and address of the taxpayer, the business in which it is engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time it was paid in, the par value of the stock specifically issued therefor, and the amount included as paid-in surplus. He is also required to furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress without regard to the restrictions ordinarily imposed on him with respect to making public the contents of any income tax return.[47]

Definition of Tangible Property. The term "tangible property" means stocks, bonds, notes and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property.[48] A contract may be treated as tangible property only after the submission of a full statement as to its exact nature showing to the satisfaction of the Commissioner that it relates to rights in tangible property to such an extent that its value arises chiefly therefrom.[48a]

EVIDENCES OF INDEBTEDNESS. Enforceable notes or other evidences of indebtedness, either interest bearing or noninterest bearing, of the subscriber received by a corporation upon a subscription for stock may be considered as tangible property in computing its invested capital to the extent of the actual cash value of such notes or other evidences of indebtedness at the time when paid in, but only

47 Revenue Act of 1918, § 326 (a).

48 Revenue Act of 1918, § 325 (a). The 1917 Law contained no definition of intangible property but the Treasury Department held that the term included stocks, bonds, bills and accounts receivable, notes and other evidences of indebtedness and leaseholds. (Reg. 41, Art. 47.)

48a Reg. 45, Art. 811.

(a) if such notes or evidences of indebtedness could under the laws of the jurisdiction in which the corporation was organized legally be received in payment for stock, and (b) if they were actually received by the corporation as absolute, and not as conditional, payment in whole or in part of the stock subscription.[49]

VALUE OF PROPERTY AS OF JANUARY 1, 1914. Under the 1917 Law the value of tangible property as of January 1, 1914, could be taken in the case where such property had been paid in for stock or shares prior to that date, but not in excess of the par value of the stock or shares. No such provision appears in the 1918 Law and the value must in all cases be determined as of the time of acquisition.[50]

Intangible Property. The term "intangible property" means patents, copyrights, secret processes and formulae, good will, trade-marks, trade-brands, franchises and other like property.[51] In the 1917 Law patents were not defined as intangible property.[52] Most contracts are intangible property and in the absence of a specific ruling by the Commissioner to the contrary should be so regarded for the purpose of making returns. Associated Press, and similar franchises, and subscription lists and mailing lists are intangible property.[52a] The actual cash value of intangible property paid in for stock or shares must be determined in the light of the facts in each case. Among the factors to be considered are (a) the earnings attributable to such intangible assets while in the hands of the prede-

49 Reg. 45, Art. 833.

50 Cf. Revenue Act of 1917, § 207 and Revenue Act of 1918, § 326.

51 Revenue Act of 1918, § 325 (a).

52 Revenue Act of 1917, § 207. Under the 1917 Law the term "other intangible property" as used in Section 207 was construed to mean property of a character similar to good will, trade marks and the other specific kinds of property enumerated in the same clause. Property not clearly of such character might be held to be tangible within the meaning of the law. (Reg. 41, Art. 47.) Patents had a status intermediate between tangible and intangible property.

52a Reg. 45, Art. 811.

cessor owner; (b) the earnings of the corporation attributable to the intangible assets after the date of their acquisition; (c) representative sales of the stock of the corporation at or about the date of the acquisition of the intangible assets; and (d) any cash offers for the purchase of the business, including the intangible property, at or about the time of its acquisition. A corporation claiming a value for intangible property paid in for stock or shares should file with its return a full statement of the facts relating to such valuation.[52b] In cases where stock has been issued for intangible property the following rules apply:

INTANGIBLE PROPERTY PAID IN PRIOR TO MARCH 3, 1917. Where intangible property was paid in prior to March 3, 1917, such intangible property becomes invested capital in an amount not exceeding (a) the actual cash value of the property at the time paid in, (b) the par value of the stock or shares issued therefor[53] or (c) in the aggregate 25% of the par value of the total stock or shares or the corporation outstanding on March 3, 1917,[54] whichever is the lowest.[55] Illustration: assume the par value of the capital stock of a corporation issued and outstanding on

52b Id., Art. 851.

53 The par value of stock or shares, in the case of stock or shares issued at a nominal value or having no par value, is deemed to be the fair market value as of the date such stock or shares are issued. (Revenue Act of 1918, § 325.)

54 Under the 1917 Law it was held that intangible property bona fide purchased prior to March 3, 1917, with stock having no par value could be included in invested capital at a value not exceeding the actual cash value of such intangible property at the time of the purchase or in an amount not exceeding 20% of the total shares of stock outstanding on March 3, 1917, measured by their value as at the date or dates of issue. (Reg. 41, Art. 58.)

55 In the case of a reorganization in which the capital stock is increased but the control of the business remains in the same hands the value of the stock issued for intangible property must be determined with reference to the capitalization of the old company and not the capitalization of the new company. (Letter from Treasury Dept. dated March 14, 1918.)

February 1, 1917, was $100,000. On February 2, 1917, it issued an additional $100,000 par value of stock for intangible property having a cash value of $100,000. Applying the foregoing rule, (a) equals $100,000; (b) equals $100,000 and (c) equals 25% of $200,000 (the par value of the stock outstanding on March 3, 1917). Therefore (c) or $50,000 is all that may be considered as invested capital representing such intangible property.

INTANGIBLE PROPERTY PAID IN ON OR AFTER MARCH 3, 1917. Where the intangible property was paid in after March 3, 1917, the invested capital with respect thereto is an amount not exceeding (a) the actual cash value of the property at the time paid in (b) the par value of the stock or shares issued therefor or (c) 25% of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is the lowest. Illustration: assume a corporation has $200,000 par value of capital stock outstanding on December 30, 1917. On December 31, 1917, it issues an additional $100,000 of capital stock for intangible property having a cash value of $100,000. Applying the foregoing rule (a) equals $100,000; (b) equals $100,000 and for the taxable year 1918 (c) equals 25% of $300,000. Therefore the invested capital representing such intangible property is $75,000. But if the same intangible property had been acquired on January 2, 1918, instead of December 31, 1917, the invested capital for 1918 representing the same value of intangible property would be only $50,000 instead of $75,000, since in that case the par value of the capital stock outstanding at the beginning of the taxable year would have been only $200,000.

WHERE INTANGIBLE PROPERTY HAS BEEN PAID IN BOTH BEFORE AND AFTER MARCH 3, 1917. Where intangible property has been paid in to a corporation before and also after March 3, 1917, a further limitation is imposed upon the value of the invested capital to represent in the aggregate all such intangible property. The law provides that in no case shall the total amount of invested capital repre-

senting intangible property paid in both before and after that date exceed in the aggregate 25% of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year. Illustration: assume the par value of the capital stock outstanding February 1, 1917, was $100,000 and that $100,000 additional was issued for intangible property of the same cash value on February 2, 1917, and a further issue of $100,000 par value on December 31, 1917, for intangible property also having an equal cash value. Applying the first and second rules stated in the preceding paragraphs it is found that the invested capital with respect to the first intangible property is $50,000 and with respect to the second intangible property is $75,000 making the total for both $125,000. But applying the third rule the total invested capital representing both the property acquired on February 2, 1917, and that acquired on December 31, 1917, is reduced in the aggregate to $75,000. If the second property had been acquired on January 2, 1918, instead of December 31, 1917, the invested capital representing both properties would be reduced even lower, namely to $50,000, which amount would then represent 25% of the par value of the capital stock of the corporation outstanding January 1, 1918.[55a]

Mixed Aggregates of Tangible and Intangible Property. Under the 1917 law it was held that where stock or shares (or stock or shares and bonds or other obligations) have been issued for a mixed aggregate of—

(a) Tangible property,

(b) Patents and copyrights, and

(c) Good will or other intangible property, the following rules would govern:

(1) In the absence of satisfactory evidence to the contrary, it was presumed in the case of a corporation, that its stock was issued for the following purposes in the order named:

[55a] As to affiliated corporations see p. 769.

(a) Good will or other intangible property,
(b) Patents and copyrights, and
(c) Tangible property.

(2) Upon the production by the taxpayer of evidence satisfactory to the Commissioner as to the actual values at the date of acquisition of (a) the tangible property and (b) the patents and copyrights, the sum of these two items could be applied against the total par value of the securities issued and the remainder was then deemed to represent the par value of the securities issued for the good will or other intangible property.

(3) Cases where mixed aggregates of tangible and intangible property have been paid in for stock and bonds were, if the Secretary was unable to determine satisfactorily the respective values of the several classes of property at the time of payment, treated as coming under the head of cases where the invested capital could not be satisfactorily ascertained and the tax was assessed accordingly.[56] The present law[57] provides that where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively, the corporation shall be assessed under Section 328.[58] The ruling under the present law is that where stock or shares and bonds or other obligations have been issued for a mixed aggregate of tangible and intangible property, it will be presumed in the absence of satisfactory evidence to the contrary that the bonds were issued for tangible property and that the stock was issued for the balance of the tangible property, if any, and for the intangible property. Where stock or shares have been issued for a mixed aggregate of tangible and

[56] Reg. 41, Art. 59.
[57] Revenue Act of 1918, § 327.
[58] See p. 762.

intangible property and certain liabilities have been assumed in connection with the transaction, it will be presumed that such liabilities are to be charged against the tangible property and the intangible property in the order named, unless it is shown by evidence satisfactory to the Commissioner that this presumption is not in accordance with the facts.[58a]

Surplus and Undivided Profits. Paid-in or earned surplus and undivided profits at the beginning of the taxable year may be included as invested capital. Surplus and undivided profits earned during the year may not be included.[59] Appreciation in values due to reappraisement cannot be regarded as paid-in or earned surplus.[60]

PAID-IN SURPLUS. Where it is shown by evidence satisfactory to the Commissioner that tangible property has been paid in by a stockholder to a corporation as a gift or at a value definitely known or accurately ascertainable as of the date of such payment clearly and substantially in excess of the cash or other consideration paid by the corporation therefor, then the amount of the excess shall be

58a Reg. 45, Art. 835.

59 Revenue Act of 1918, § 326 (a). Under the 1917 Law some doubt existed as to whether or not surplus earned during the taxable year and actually employed in the business during a part of that year could not be included in invested capital. The Treasury Department ruled that it could not in the case of corporations and partnerships (Reg. 41, Art. 61) even though invested in bonds of the United States (T. D. 2541) or set up as "surplus" on the books or distributed in the form of stock dividends (Reg. 41, Art. 61) but that profits earned during the year could be included as invested capital of individuals (Id. Art. 69). The 1917 Law also provided that surplus or individual profits in order to be included in invested capital should be "used or employed in the business," but the distinction, if any exists, between assets used and assets not used in the business of a corporation was too fine for practical purposes, and since the law elsewhere provided that all the income of a corporation should be deemed to be received from its trade or business, the Treasury Department ruled that all surplus or undivided profits would be deemed to be employed in the business, unless invested in inadmissible assets (Id. Art. 62).

60 Letter from Treasury Department dated March 5, 1918.

deemed to be paid-in surplus. Substantially the same kind of evidence will be required to show the value in this case as is required in the case of tangible property paid in at a value greater than the par value of the shares issued therefor.[61]

EARNED SURPLUS. Only true earned surplus and undivided profits can be included in the computation of invested capital, and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the correct amount. In the computation of earned surplus and undivided profits full recognition must first be given to all expenses incurred and losses sustained from the original organization of the corporation down to the taxable year, including among such expenses and losses reasonable allowances for depreciation, obsolescence, or depletion of property (irrespective of the manner in which such property was originally acquired), and for the amortization of any discount on its bonds. There can of course be no earned surplus or undivided profits until any deficit or impairment of paid-in capital due to depletion, depreciation, expense, losses, or any other cause has been made good. Where adequate evidence is presented that the amounts written off or deducted in previous returns of net income are in the aggregate incorrect or unreasonable, adjustments must be made, and the taxpayer will be allowed a refund in respect of any taxes overpaid in prior years, or in the case of an underpayment of taxes will be additionally assessed.[61a] Depletion, like depreciation, must be recognized in all cases in which it occurs. Depletion attaches to each unit of mineral or other property removed, and the denial of a deduction in computing net income under the Act of August 5, 1909, or the limitation upon the amount of the deduction allowed under the Act of October 3, 1913, does not relieve the corporation of its obligation to make proper provision for depletion of its

61 Reg 45, Art. 837.
61a Id., Art. 838.

property in computing its surplus and undivided profits. Adjustments in respect of depreciation or depletion in prior years will be made or permitted only upon the basis of affirmative evidence that as at the beginning of the taxable year the amount of depreciation or depletion written off in prior years was insufficient or excessive, as the case may be. Where deductions for depreciation or depletion have either on the books of the corporation or in its returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.[61b]

Reserves. The amounts shown on the balance sheet as reserves may or may not be included as invested capital depending upon the character of the reserve. Some reserves are merely subdivisions of the surplus account and are true surplus or undivided profits. Such reserves are, for instance, reserves for bad debts, reserves for contingencies, reserves for self-insurance, and reserves for Federal income and excess-profits tax. Any reserve the additions to which cannot be deducted as an expense in the return of net income, may be considered as a part of the surplus and undivided profits for the purpose of invested capital. On the other hand, with perhaps only one exception, reserves, the additions to which may be deducted in ascertaining net income, cannot be included as invested capital. Among such reserves are reserves for depreciation (which are presumed to offset the loss in the assets) and reserves for state or local taxes in cases where the corporation reports on an accrual basis and the amounts carried to such reserves have been deducted as expense. An exception to this general rule would appear to exist in the case of reserves for depreciation or depletion based upon the value of the property as of March 1, 1913. These exceptional cases are referred to in the following paragraphs.

61b Id., Art. 839.

Reserves for Taxes. Reserves set aside out of surplus or undivided profits of preceding years for payment of Federal taxes or state taxes not yet due can be included in invested capital for the taxable year if, and to the extent that, such taxes were not allowable deductions in computing net income for the preceding taxable year. Inasmuch as Federal income and excess-profits taxes are not deductible in computing the respective net incomes subject to such taxes, reserves set aside for the payment of such taxes may be included in invested capital.[62] But amounts payable on account of income and excess-profits taxes for any year may be included in computing the surplus and undivided profits for the succeeding year only for the proportionate part of the year represented by the period of time between the close of the taxable year and the date or dates on which such taxes become due and payable.[63] A deduction from the invested capital as of the beginning of the taxable year must therefore be made for such taxes or any installment thereof, averaged for the proportionate part of the taxable year after the date when the tax or the installment is due and payable. Where as a result of an audit by the Commissioner, or the acceptance of an amended return, or for any other reason, the amount of any such tax for the preceding year is subsequently changed, a corresponding adjustment will be made in the invested capital for the taxable year upon the same basis as if the corrected amount of the tax for the preceding year had been used in the

[62] Letter from Treasury Department dated March 20, 1918, W. T. S. 1918, ¶ 911.

[63] T. D. 2791. Prior to this ruling it was uncertain whether or not a corporation which indicated on its books of account that the excess-profits tax imposed on the income for 1917 was paid out of the earnings of 1918 need reduce its invested capital by reason of such payments. It was argued that the corporation had the option of paying the tax from either the income of 1917 or the income of 1918. This ruling is intended to apply a uniform rule in all cases regardless of whether or not the corporation set up a part of its surplus as reserves for Federal taxes.

original computation of the invested capital for the taxable year.[64]

Reserve for Depreciation or Depletion. If any reserves for depreciation or for depletion are included in the surplus account it should be analyzed so as to separate such reserves and leave only real surplus. Reserves for depreciation or depletion can not be included in the computation of invested capital, except to the following extent: (1) Excessive depletion or depreciation included therein and which if charged off could be restored under article 840 may be included in the computation of invested capital; and (2) where depreciation or depletion is computed on the value as of March 1, 1913, or as of any subsequent date, the proportion of depreciation or depletion representing the realization of appreciation of value at March 1, 1913, or such subsequent date, may if undistributed and used or employed in the business be treated as surplus and included in the computation of invested capital. For the purpose of computing invested capital depreciation or depletion computed on the value as of March 1, 1913, or as of any subsequent date shall, if such value exceeded cost, be deemed a pro rata realization of cost and appreciation and be apportioned accordingly. Except as above provided value appreciation (even though evidenced by an appraisal) which has not been actually realized and reported as income for the purpose of the income tax can not be included in the computation of invested capital, and if already reflected in the surplus account it must be deducted therefrom.[64a]

Patents. From the standpoint of assets a patent, or more particularly a group of patents, is closely analogous to good will. Their value is contingent upon and measured by their earning power. While patents have a definite life there is a common tendency to extend that life by improvements upon the original, and in a successful business the patent value merges more or less completely

[64] Reg. 45, Art. 845. See p. 734 for Art. 840.
[64a] Id., Art. 844.

into a trade name or other form of good will. Therefore, while deductions in respect to the depreciation of patents based upon a normal life period of seventeen years are allowable in computing net income for the purpose of the income tax, such deductions are not obligatory, but are optional with each taxpayer. Where since January 1, 1909, a corporation has exercised that option to its own benefit in computing its taxable net income the amount so deducted can not now be restored in computing invested capital. Where, however, the cost of patents has been charged against surplus or otherwise disposed of in such a manner as not to benefit the corporation in computing its taxable net income since January 1, 1909, any amount so written off may be restored in computing invested capital, if it be shown to the satisfaction of the Commissioner that the amount so written off represented a mere book entry ascribable to a conservative policy of management or accounting and did not represent a realized shrinkage in the value of such assets. Any amount so restored may not be written off by way of deductions from taxable net income in any subsequent year or years. Where a corporation has charged to current expenses the cost of developing or protecting patents, no amount in respect thereof expended since January 1, 1909, can be restored in computing invested capital. In respect of expenditures made before January 1, 1909, a corporation now seeking to restore them must be prepared to show to the satisfaction of the Commissioner that all such items are proper capital expenditures. It can not be said that the correct computation of surplus and undivided profits necessarily requires a deduction in respect of the expiration of patents. It follows, therefore, that where a corporation in the exercise of its option has not written down the cost of patents, it is not ordinarily necessary to reduce the surplus and undivided profits in computing invested capital, whether the patents have been acquired for stock or shares or for cash or other tangible property.

Due consideration will be given to the facts in any case in which this rule seems obviously unreasonable.[64b]

Property Taken for Debt. Real or personal property taken by a corporation in payment or satisfaction of a debt can not be included as an admissible asset or reflected in the surplus account at an amount in excess of either (a) its actual value as of the beginning of the taxable year or (b) the amount of the debt in payment of which it was taken.[65]

Discount on Sale of Bonds. Discount allowed on the sale of bonds is in effect an advance on account of interest, so that the effective rate of interest in such a case is equal to the sum of the nominal rate plus the rate necessary to amortize the discount over the life of the bonds. Where, under incorrect accounting practices, the discount on bonds has been charged to a property account or otherwise carried as an asset, and is so reflected in the surplus account, it is necessary in computing invested capital to make an adjustment in respect of such discount.[65a]

Bank Discount. Only the amount of discount which has actually been reported by a bank in a prior year as taxable income and credited to surplus account may be included in surplus as of the beginning of the taxable year.[65b]

Current Profits. Profits earned during any year can not be included in the computation of invested capital for that year, even though during the year such profits are set up as surplus on the books or assumed to be distributed in the form of stock dividends. If a dividend is declared and paid during any year out of the profits of that year and the stockholders pay back into the corporation all or a substantial part of the amount of such dividends, the amount so paid back can not be included in the computation of invested capital unless the corpora-

64b Id., Art. 843.
65 Id., Art. 847.
65a Id., Art. 848.
65b Id., Art. 849.

tion shows by evidence satisfactory to the Commissioner that the dividends were paid in good faith and without any understanding, express or implied, that they were to be paid back.[65e]

Surrender Value of Insurance Policies. Premiums paid by a corporation for insurance on the lives of its officers and employees payable to it cannot be deducted as expenses in computing taxable income. Such insurance policies are considered tangible property and may be included as invested capital of the corporation at their cash surrender value at the beginning of the taxable year.[66]

Additions to Surplus Account. A corporation's books of accounts will be presumed to show the facts. If it claims that its capital or surplus account is understated the burden of proof will rest upon it. Additions to such accounts will be accepted to the following extent:

(1) Excessive depreciation heretofore charged off on property still in use, if it is now shown by satisfactory proof to have been excessive and such excess is substantial in amount, whether or not disallowed by the Commissioner as a deduction from net income, may be restored to the surplus account. No such amount shall be restored, however, unless it is shown that adequate depreciation has been deducted upon all other property of the corporation still in use, nor in any case in which such amount has been allowed as a deduction for amortization under Section 234 (a) (8) of the statute, or in which the cost of the property has been recovered through being included in the price of goods or services, as for example, in the case of patterns, dies, plates, special tools, etc., or under a munition contract with a foreign government.

(2) Amounts which have been expended before January 1, 1917, for the acquisition of plant, equipment, tools, patterns, furniture, fixtures, or like tangible property, having a useful life extending substantially beyond the year in which the expenditure was made, and which have

[65e] Id., Art. 850.
[66] Reg. 45, Art. 846.

been charged as current expense, may (less proper deductions for depreciation or obsolescence) be added to the surplus account when such assets are still owned and in active use by the corporation during the taxable year. Special tools, patterns, and similar assets shall not be assigned any value if their cost has been recovered through having been included in the price of goods. If their cost has not been so recovered and they are held for only occasional use, they shall not be assigned a value in excess of the fair value based upon the earnings actually arising from their current use, and in no case shall such value be more than the cost less depreciation. Assets of this kind not in current use shall not be valued at more than their nominal or scrap value.

(3) Amounts which have been expended in the past for intangible property of any kind can be restored to capital or surplus account only to the extent that the corporation specifically paid such amounts for the intangible property as such.[67]

(4) Adjustments necessary to correct other errors found in the books of account may be made.[67a]

Limitation of Additions to Surplus. Additions to surplus which a corporation may desire to make under the preceding article fall broadly into two classes:

(1) To correct returns of net income for prior years in which actual errors have been made, as for example where excessive depreciation has been deducted, additions to plant and equipment or other capital charges have been charged off as an expense, inventories have been taken upon a wrong basis of valuation, etc.

67 It was also held under the 1917 Law that although large sums may have been spent in advertising and thereby an extensive good will may have been created the sums so spent could not be considered as amounts paid for good will if the amounts were charged to general expense from time to time. Good will could be included only when bought and paid for specifically as such. (Letter from Treasury Department dated March 5, 1918.)

67a Reg. 45, Art. 840.

(2) To reinstate in surplus deductions from income which are as a matter of good accounting to some extent optional, such as experimental expenses, patent litigation, development of good will through advertising or otherwise, etc. Adjustments falling in class (1) will be permitted for all years whether before or after March 1, 1913, provided amended returns of net income are filed for each year in which an erroneous return has been made. Due consideration will be given to the assessment of penalties in any case in which a fraudulent return has been made. Adjustments falling in class (2) cannot be permitted, as in such cases it is considered that the corporation has exercised a binding option in deducting such expenses from income. An election of this sort which was made concurrently with the transaction cannot now be revised, and amended returns in respect thereof cannot be accepted. The corporation shall submit with its return a statement of the additions proposed, specifying the kinds and amounts of property involved, the years in which the expenditures were made, and the method followed in distinguishing between capital outlays and current expenses, and showing that adequate provision has been made for depreciation, obsolescence and depletion of such of the assets affected by the additions as are subject to recognized depreciation, obsolescence or depletion. In any case in which there is an operating deficit amounts restored must first be set off against the deficit and only the excess can be actually included in the computation of invested capital.[67b]

Property Paid in and Subsequently Written Off. Where tangible or intangible property has been paid in to a corporation for stock or shares or as paid-in surplus, and has subsequently been in whole or in part written off the books, the amount so written off may upon evidence satisfactory to the Commissioner be restored to the capital or surplus account subject to the following limitations: (1) The amount restored must be reduced by a proper

[67b] Id., Art. 841.

deduction for any depreciation, obsolescence or depletion; and (2) the aggregate amount included in computing invested capital on account of such property shall not exceed the amount which might have been included if such property had not been written off.[68]

Admissible Assets. The term "admissible assets" means all assets other than inadmissible assets, valued in accordance with the provisions of the law regarding invested capital.[69] Organization expenses and deferred charges against future income are admissible assets.[70]

Inadmissible Assets. The term "inadmissible assets" means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income. Where however the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the interest derived from such assets is in effect included in the net income because of the limitation of the deduction of interest under Section 234 of the Income Tax Law the corresponding part of such assets are not deemed to be inadmissible.[71] A corporation cannot by including the income from inadmissible assets as taxable income create the right to have such assets considered admissible assets.[71a] Inadmissible assets will for the purpose of discussion in the following paragraphs be divided into three classes, (1) stocks of domestic corporations (2) stocks of foreign corporations and (3) bonds and other obligations.

STOCKS OF DOMESTIC CORPORATIONS. The law apparently intends that stocks of domestic corporations are *ipso facto* inadmissible assets in computing the invested capital of the stockholder. The law provides that the term "inad-

68 Reg. 45, Art. 842.
69 Revenue Act of 1918, § 325.
70 Reg. 45, Art. 818.
71 Id. § 325.
71a Reg. 45, Art. 815.

missible assets" means "stocks * * * the dividends * * * from which is [are] not included in computing net income." Hence it follows that it is immaterial whether the corporation whose stock is held actually pays dividends thereon or not or whether its operations are carried on within or without the jurisdiction of the United States. Although many corporations find it necessary for business reasons to hold stock in other corporations which do not pay dividends and such investment is in fact a necessary and proper investment, as for instance where several corporations may own the stock of storage, warehouse or terminal companies for their joint benefit (such jointly held corporation not being intended to pay dividends) the stock is nevertheless inadmissible under a literal interpretation of the law. To hold that stock of a domestic corporation is admissible if the corporation paid no dividends during the taxable year but inadmissible if the corporation paid dividends and the same were not included in the net income of the stockholer, would be to establish an impracticable rule, and one plainly not intended by the language of the law. Hence, it has been ruled that the failure to pay or to receive dividends does not change the status of stock as an inadmissible asset.[71b] Apparently the only way that stock of a domestic corporation can become an admissible asset is by selling the stock, in which case the profit is included in net income and all or a portion of the value of the stock becomes an admissible asset, as is more fully stated in a subsequent paragraph.

STOCK OF FOREIGN CORPORATIONS. The amount of stock of a foreign corporation held by a taxpayer which may be treated as an admissible asset of the stockholder depends upon the amount of net income of the foreign corporation from sources outside of the United States as compared with its entire net income.[72] Thus, if A equals the total amount of the stock of a foreign corporation owned by the taxpayer; X equals the value to be consid-

71b Id.

72 Reg. 41, Art. 46.

ered as an admissible asset; B equals the entire net income of the foreign corporation and C equals the net income from sources outside the United States during the taxable year, then A is to X as B is to C. It follows of course that the amount of any dividend paid on such stock to be included in taxable income of the stockholder would be determined by a similar proportion in which A equals the total amount of dividends received during the year and X the amount of such dividends which are taxable.[73] In case the foreign corporation has paid no dividends during the year the amount of stock to be considered as an inadmissible asset is nevertheless to be determined by the first proportion. In case the foreign corporation had no net income from sources in the United States but income from other sources during the taxable year, the computation under this ruling would make the entire value of the stock an admissible asset, whether or not the foreign corporation may have had capital invested in this country.

Bonds or Other Obligations. The bonds or other obligations which are inadmissible assets are only those "the interest from which is not included in computing net income." Bonds and securities of industrial or railroad corporations—domestic or foreign—are admissible, even though the bond may have a so-called "tax-free covenant." Bonds issued by exempt corporations are admissible assets. Bonds and obligations of the United States are admissible although the interest may be exempt. Such bonds however are only bonds of the Federal Government and not of its possessions.[74] Bonds and obligations which are inadmissible assets are those issued by a state or territory (or a political subdivision of either, i. e., county, city, township, etc.), the District of Columbia and the possessions of the United States, and also securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916. Bonds of the War Finance Corporation

[73] Reg. 41, Art. 27.
[74] Reg. 45, Art. 816.

are admissible if the income therefrom is subject to the tax but such part of the principal amount of such bonds with respect to which interest may be exempt from excess-profits tax is inadmissible.

Inadmissible Assets May Become Admissible. Under two conditions assets which are otherwise inadmissible become in whole or in part admissible. (1) Where the inadmissible asset has been sold during the year and the profit thereon is included in net income and (2) where inadmissible assets have been purchased or carried during the year with borrowed money and the interest paid on such borrowed money is not allowed to be deducted in ascertaining the net income.[75] Where inadmissible assets have been sold or otherwise disposed of the total income from such assets including the profit on the sale and the interest or dividends received during the year is first ascertained. Secondly the percentage of the entire net income attributable to the profit on the sale of the asset is ascertained and the same percentage of the intangible asset becomes invested capital for the length of time such asset was owned by the corporation.[76] In the second class of cases it seems that the interest received from the inadmissible asset should be compared with the interest paid upon the money borrowed to purchase or carry such asset. Thus, if the interest received is $100 and the interest paid on the borrowed money is $75 three-fourths of the inadmissible asset becomes admissible (since three-fourths of the interest is in effect included in taxable income).

75 See Revenue Act of 1918, § 234 (a) 2, also p. 446.

76 Under the 1917 Law it was held that wherever income consisted partly of gains or profits subject to the excess-profits tax arising from trading in stocks, bonds, etc., the dividends or interest on which were not subject to such tax, and partly from such dividends or interest, there could be included in the invested capital and amount which bore the same ratio to the total amount invested in such stock or bonds as the amount of such trading profits bore to the total amount of trading profits and dividends or interest. (Reg. 41, Art. 45.)

Reduction of Invested Capital by Inadmissible Assets. From invested capital must be deducted a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the year.[77] That is, after the invested capital has been determined without reference to inadmissible assets but eliminating borrowed capital, the invested capital so determined is reduced by taking a percentage equal to the percentage of inadmissible assets to all the assets held during the taxable year.[78] For the purpose of ascertaining the deductible percentage the amount of inadmissible assets held during the year may ordinarily be determined by dividing by two the sum of the amount of such assets held at the beginning of the year and the amount held at the end of the year. The total amount of admissible and inadmissible assets held during the year may ordinarily be determined by dividing by two the sum of the amount of such assets held at the beginning of the year and the amount at the end of the year. If at any time a substantial change has taken place either in the amount of inadmissible assets or in the total amount of admissible and inadmissible assets, the effect of such change shall be averaged exactly from the date on which it occurred. In any case where the Commissioner finds that either amount determined as above provided does not substantially reflect the average situation throughout the year, and that the amount of each kind of assets held on a given day of each month throughout the year or at more frequent regular intervals can be determined, the amount of inadmissible assets and the amount of both kinds of assets held during the year shall be determined by averaging the amounts held at such several times. In

77 Rev. Act of 1918, § 326 (b).

78 Under the 1917 Law it was ruled that only so much of the admissible assets as exceeded the borrowed money need be deducted from invested capital. See letter from Treasury Department dated April 2, 1918, W. T. S. 1918, ¶ 923 and letter dated May 17, 1918, Id. ¶ 955.

making these computations the valuation at which each asset is carried shall be adjusted in accordance with the provisions of the statute and of the regulations relating to the valuation of assets for the purpose of computing invested capital. It is immaterial whether such assets were acquired out of invested capital or out of profits earned during the year or borrowed capital.[78a]

Borrowed Capital. The term "borrowed capital" means money and other property borrowed whether represented by bonds, notes, open accounts, or otherwise.[79] Invested capital does not include borrowed capital.[80] Where the amount of borrowed capital is abnormal, however, the taxpayer may apply for relief under Section 327 of the law.[81] Any interest in a corporation represented by bonds, debentures or other securities, by whatever name called, including so-called preferred stock, if with respect to the payment of either interest or principal it ranks with or prior to the interest of the general creditors, is borrowed capital and cannot be included in computing invested capital. Any such preferred stock may, however, be so included if it is deferred with respect to the payment of both interest and principal to the interest of the general creditors.[81a] Whether a given amount paid into or left in the business of a corporation constitutes borrowed capital or paid-in surplus is largely a question of fact. Thus, indebtedness to stockholders actually cancelled and left in the business would ordinarily constitute paid-in surplus, while amounts left in the busi-

78a Reg. 45, Art. 852. As to affiliated corporations see p. 770.

79 Rev. Act of 1918, § 325 (a). Under the 1917 Law it was held that the term "money or other property borrowed" included not only cash or other borrowed property which could be identified as such, but current liabilities and temporary indebtedness of all kinds, and any permanent indebtedness upon which the taxpayer was entitled to an interest deduction in computing net income. (Reg. 41, Art. 44.)

80 Rev. Act of 1918, § 326 (b).

81 See p. 763.

81a Reg. 45, Art. 812.

ness representing salaries of officers in excess of their actual withdrawals, or deposit accounts in favor of partners in a partnership succeeded by the corporation, will be considered paid-in surplus or borrowed capital according to the facts of the particular case. The general principle is that if interest is paid or is to be paid on any such amount, or if the stockholder's or officer's right to repayment of such amount ranks with or before that of the general creditors, the amount so left with the corporation must be considered as borrowed capital.[81b] Items such as deposits or amounts due to other banks shown in the balance sheet of a bank, unexpired subscriptions shown in the balance sheet of a publishing concern, etc., are deemed liabilities and can not be included in computing invested capital.[81c]

Computing Invested Capital. In computing invested capital the first step is to add together the paid-in capital and paid-in or earned surplus and undivided profits (under whatever name the same may be called) as shown by the books at the beginning of the taxable year. The total thus obtained is to be adjusted for any asset or item which it covers that is not carried on the books at the valuation prescribed by law.[82] After the various adjustments are made the adjusted total of the capital and surplus account will represent the invested capital at the beginning of the taxable year. If there has been any change made during the taxable year in the amount of invested capital the reduction or increase must be noted in order to average the invested capital for the year. Whenever any corrections are made in respect of the capital stock or surplus corresponding corrections must be made in the respective asset items in the balance sheet of the taxpayer accompanying the return.[83] But it is not

[81b] Id., Art. 813.
[81c] Id., Art. 814.
[82] This was the rule under the 1917 Law. See Reg. 41, Art. 53.
[83] Reg. 41, Art. 53.

necessary that the books also be changed provided some permanent record of the adjustments be kept.[84]

Adjustments Which Increase Book Values of Assets. The adjustments which may increase the book value of the assets representing capital and surplus at the beginning of the year (and thus increase the surplus for purpose of invested capital) are stated in the preceding paragraphs. Briefly summarized they are (a) the value of intangible property paid in in excess of the par value of the stock issued therefor; (b) additions to the capital account due to restoring to the capital account the value of assets the cost of which has been charged to expense; (c) reinstating the value of assets which have been unduly reduced on the books of the company, and (d) the inclusion of reserves or such parts of reserves as are in fact surplus or undivided profits. In support of the claim for additional invested capital with respect to any of these items it is necessary to file statements showing the information indicated in the respective paragraphs above.

Adjustments Which Reduce the Book Value of Assets. Assets may be carried on the books at a valuation greater than that which the law expressly allows or contemplates. In such cases the value of such assets must be reduced to within the limit allowed by law and the capital surplus or undivided profits of a company reduced accordingly. Cases in which adjustment must be made to reduce the book value are stated in the following paragraphs.

As to Value of Intangible Assets. As stated above in the paragraphs relating to intangible property paid in[85] the value thereof must be reduced to the lowest of three values: (a) the actual cash value at the time of acquisition; (b) the par value of the stock issued therefor, or (c) 25% of the par value of the stock outstanding on March 3, 1917, or at the beginning of the taxable year as the case may be. The difference between such minimum value and the value at which the assets are carried on the

[84] Letter from Treasury Department dated March 19, 1918.

[85] See p. 722.

books of the company is the amount to be deducted in this adjustment.

As to Treasury Stock. When any treasury stock is returned to the corporation as a gift or for a consideration substantially less than its par value, the stock so returned shall not be treated as a part of the stock issued or exchanged for property. The proceeds derived in cash or its equivalent from the resale of such treasury stock should however be included in the invested capital if retained and employed in the business.[86] The difference between the par value of the treasury stock so returned as a gift and the amount of cash or its equivalent which was derived from the resale of such stock is required to be deducted from invested capital.[87] Where a corporation either directly or indirectly, as for example through a trustee, has prior to the taxable year bought its own stock, either for the purpose of retirement or of holding it in the treasury or for other purposes, the entire cost of such stock must be deducted from the aggregate invested capital as of the beginning of the taxable year, if such deduction has not already been made. Where such stock is purchased during the taxable year a deduction from the invested capital as of the beginning of the taxable year and effective from the date of such purchase is required only to the extent that such stock has not been purchased out of the undivided profits of the taxable year. The full amount derived in cash or its equivalent from the resale of such stock may be included in the invested capital from the date of such resale.[88]

As to Value of Assets Acquired in Reorganization. In the case of a reorganization, consolidation or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917, certain reductions may be necessary in the book values of the new owner if such book values reflect the value of the property at the time

86 Reg. 41, Art. 54; Reg. 45, Art. 861.
87 See Form 1120 for 1918, Schedule G3.
88 Reg. 45, Art. 862.

it was acquired by such new owner. Such reduction is necessary only in cases where 50% or more of the interest or control of such new corporation remains in the same persons (or any of them) who owned the asset acquired by such corporation. In such cases no asset so acquired shall for the purpose of determining invested capital, be allowed a greater value than would have been allowed in computing the invested capital of the previous owner if such asset had not been so transferred to the new owner. That is, if the previous owner was a corporation and 50% or more of the interest or control of the new corporation remains in the hands of any of those who controlled the old corporation, the invested capital of the new corporation cannot be increased beyond the amount which would have been allowed to the old corporation had it retained the assets. This is true whether or not the assets were paid for by the new corporation in stock or in cash.[89] If the previous owner was not a corporation, then the value of any asset so transferred shall be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost shall be made for any charge or expenditure deducted as expense or otherwise on or after March 1, 1913, in computing the net income of such previous owner for purpose of taxation.[90] In all such cases the reduction to be made is the difference between the book value of such assets and (a) in the case of a previous owner being a corporation, the value at which the asset would have been considered invested capital to it, or (b) in the case of an individual being the previous owner, the cost of such asset to such owner as indicated above.

[89] Under the 1917 Law this restriction on the value of assets acquired on a reorganization after March 3, 1917, applied only to cases where the asset was not paid for specifically as such in cash or tangible property, but under the present law it applies only to cases where payment may have been made in cash or by tangible property.

[90] Rev. Act of 1918, § 331.

As to Values Marked up on the Books of Account. Invested capital cannot be based upon an appraisement showing the value as of any date subsequent to the date of acquisition.[91] Therefore if a corporation has marked up the value of any of its assets the amount by which the original book values have been increased must be deducted.

As to Inadequate Allowance for Depreciation or Depletion. Where the corporation has not duly marked down the value of its property subject to depreciation, or set up a depreciation reserve to provide for replacement of values lost by depreciation, from the time the property was acquired down to the beginning of the taxable year, the proper amount of depreciation suffered during that period must be computed and deducted from the value of the assets in order to reach their present value at the beginning of the taxable year.[92] In the case of a corporation, however, which has no surplus and which has had no income prior to the taxable year against which to deduct depreciation, it seems that the original value of the property at the date of acquisition need not be reduced under this head, since the law contemplates that the invested capital shall be measured by the value of the original contribution of the stockholder to the corporation. Similar reduction must also be made in case of inadequate allowance for depletion.[92a]

As to Losses. Where a loss has taken place, and the value of the asset has not been marked down accordingly, the amount of such loss must be deducted in this adjustment. But where a loss has taken place it will be taken into account only to the extent that it has wiped out the surplus. The amount of the original capital contributed by the stockholders is not reduced by reason of the loss, but no new surplus can be included as invested capital until the full loss chargeable against the capital account

91 Letter from Treasury Department dated March 5, 1918.
92 See Reg. 41, Art. 42.
92a See p. 728 for statement of rule.

has been made good.[93] It seems that a corporation to which a certain amount of capital was once contributed, and which has not paid back any part thereof to its stockholders, either directly or indirectly, is allowed to claim the entire amount originally contributed as invested capital, regardless of losses which may have impaired such capital, provided the corporation has no surplus against which the loss can be charged. In other words a corporation which has a deficit instead of a surplus may disregard the deficit in the computation of its invested capital. Losses which must be taken into consideration under this adjustment are those which have been actually sustained. The mere depreciation in market value of assets is not considered to be a loss impairing invested capital. Thus, stock of other corporations may have been purchased at par and at the beginning of the taxable year may have a market value of only 75. Nevertheless until the stock is sold it may for purpose of invested capital be carried at its original cost, and if the corporation has marked the value down to market it may restore the value to original cost for the purpose of this tax. On the other hand such marking down of assets to market (except in the case of dealers who inventory their stock) does not create a loss which may be deducted in computing the net income. In the case of such dealers the inventory value would govern and the cost value cannot be restored.

As to Inadmissible Assets. The adjustment by way of reduction of invested capital which must be made with respect to inadmissible assets is indicated in the preceding paragraph on that subject.[94] In the case of a corporation which has no borrowed money the reduction will equal the value of the inadmissible assets. In case the corporation has borrowed money the amount to be deducted is arrived at by deducting such proportion of the invested capital (excluding borrowed capital) as the proportion

93 Letter from Treasury Department dated March 19, 1918; Reg. 45, Art. 860.

94 See p. 741.

of inadmissible assets is to the total of inadmissible and admissible assets. Under the 1917 Law adjustments for inadmissible assets were made on the theory that the borrowed money was used to purchase or carry the inadmissible assets and only the excess of such assets over the borrowed money was deducted from invested capital. Under the present law, the adjustment seems to be on the theory that capital, surplus and borrowed money are represented by the inadmissible assets in proportion to the amount that each bears to the aggregate capital, surplus and borrowed money.

Adjustments Due to Changes in the Taxable Year. After the invested capital has been ascertained as at the beginning of the year certain adjustments may be necessary to ascertain the average invested capital during the year, which is the amount contemplated by the law.[95] The invested capital as of the beginning of any period of one year or less should be adjusted by an appropriate addition or deduction for each change in invested capital during the period. The amount so added or deducted in each case is the amount of the change average for the time remaining in the period during which it is in effect.[96] The fraction used in finding such average is the number

[95] Rev. Act of 1918, § 326 (d).

[96] The 1917 Law provided that the invested capital should be "averaged monthly" but the Treasury Department instead of adopting a monthly average required the invested capital to be averaged from the day on which the change took place. (See Form 1103 for 1917, Schedule D). Under that law the following rules were made for ascertaining the average invested capital: (a) Add the capital for each of the several months during which no change occurs, and the average capital (ascertained as provided in subdivision (b) of this paragraph) for each month in which a change occurs and divide the total by the number of months in the year or period. (b) To ascertain the capital for any month in which a change occurs multiply the capital as of the first day of the month by the number of days it remains constant and the capital after each change by the number of days (including the day on which the change occurs) during which it remains constant, add the products, and divide the sum by the number of days in the month. (Reg. 41, Art. 43.)

of days remaining in the period (including the day on which the change occurs) over the number of days in the period. Thus if a return is made for the calendar year ending December 31, 1918, and if $100,000 of additional capital was paid in on February 17, 1918, this addition to the invested capital is in effect for 318 days, and the amount to be added to the invested capital as of the beginning of the year would be 318/365 of $100,000 or $87,-123.29. If $50,000 of this amount was withdrawn on October 31, 1918, the amount to be deducted would be 62/365 of $50,000, or $8,493.15.[96a]

Dividends Paid from Surplus. The law expressly provides that any distribution of dividends made during the first sixty days of the year shall be deemed to have been made from the earnings or profits accumulated during the preceding taxable years.[97] A dividend other than a stock dividend affects the computation of invested capital from the date when the dividend is payable and not from the date when it is declared, except that where no date is set for its payment the date when declared will be considered also the date when payable. For the purpose of computing invested capital a dividend paid after the expiration of the first sixty days of the taxable year will be deemed to be paid out of the net income of the taxable year to the extent of the net income available for such purpose on the date when it is payable. The method of determining available net income is stated in the next paragraph. The surplus and undivided profits as of the beginning of the taxable year will be reduced as of the date when the dividend is payable by the entire amount of any dividend paid during the first sixty days of the taxable year and by the amount of any other dividend in excess of the current net income available for its payment. From the date when the dividend is payable the amount which the several stockholders are entitled to receive will be treated as if actually paid to them, whether or not it is so paid in fact.

96a Reg. 45, Art. 853.

97 Rev. Act of 1918, § 201 (e).

and the surplus and undivided profits, either of the taxable year or of the preceding years, will in accordance with the foregoing provisions be deemed to be reduced as of that date by the full amount of the dividend. Amounts paid to stockholders in anticipation of dividends, or amounts withdrawn by stockholders in excess of dividends declared, will in computing invested capital have the same effect as if actually paid as dividends.[98]

METHOD OF DETERMINING AVAILABLE NET INCOME. Whether at the time of any payment made during the taxable year there is sufficient income of the taxable year available for such payment, or whether the surplus or undivided profits as of the beginning of the taxable year must be reduced by the amount of such payment, will be determined according to the following principles:

(1) The aggregate amount of earnings of the taxable year available for all purposes up to any given date will, unless otherwise shown by the books, be determined upon the basis of the same proportion of the net income for the taxable year (as finally determined for the purpose of income and excess profits taxes) as the part of the year already elapsed is of the entire year.

(2) The aggregate amount available will be deemed to be applied for the following purposes in the order in which they are stated: (a) accrued federal income and war excess-profits taxes for the taxable year; (b) dividends paid after the expiration of the first sixty days of the taxable year; and (c) other corporate purposes, including the purchase of outstanding stock of the corporation previously issued.

(3) Where the amount available is determined by prorating the net income for the year, and as a result of an audit of a return by the Commissioner, the acceptance of an amended return or any other reason, the amount of the net income is subsequently changed, a corresponding adjustment will be made in the invested capital in so far

98 Reg. 45, Art. 858.

as it is affected by this article, upon the same basis as if the corrected amount of the net income had been used in the original computations under this article.[99]

EFFECT OF STOCK DIVIDEND. The payment of a stock dividend has no effect upon the amount of invested capital. Such items as appraised value of good will, appreciation in value of real estate or other tangible property, etc., although carried to surplus and distributed as stock dividends, can not in this manner be capitalized and included in computing invested capital. If a corporation has paid a stock dividend in excess of its true surplus, it can not be deemed to have any greater invested capital than could have been computed had no such stock dividend been paid.[99a]

INCREASE OF CAPITAL STOCK. If the capital stock is increased during the taxable year the invested capital will be considered to have been increased from and after the dates on which the cash or property for which such stock is issued are paid in.[99b]

REDUCTION OF CAPITAL STOCK. If the capital stock is reduced during the year the invested capital will be considered to be reduced accordingly from and after the dates on which the assets representing such reduction of capital stock are paid to the stockholders.[99c] The mere reduction of the authorized capital without a distribution of the assets will not affect the invested capital.

PAYMENT OF PRECEDING YEAR'S EXCESS-PROFITS TAX. The amounts payable on account of income and excess-profits tax for any year may be included in computing surplus and undivided profits for the succeeding year only for the proportionate part of the year represented by the period of time between the close of the taxable year and the date or dates upon which such taxes become due and

[99] Id., Art. 857.
[99a] Reg. 45, Art. 859.
[99b] See p. 749.
[99c] Id.

payable.[100] Income and excess-profits taxes are deemed to have been paid out of the net income for the taxable year for which such taxes are levied [101] and it seems immaterial whether or not a reserve was set up for such taxes or whether or not sufficient earnings of the current year were on hand when such taxes were actually paid.

REDUCTION OF RESERVES. If payments are made out of any reserves set up on the books of the company, which reserves are in fact a part of the surplus and have been included as invested capital at the beginning of the year, the invested capital is not reduced by such payments if the payments are such as may properly be charged against the net income for the current year under the law. Thus if a corporation is carrying a self-insurance reserve and sustains a loss in 1918 due to fire or other casualty, it may deduct that loss against the 1918 income although on its books the loss may be charged against the reserve. In such case the reserve is not reduced for purpose of invested capital. If however payment is made out of the reserves for any expenditure which is not deductible from the 1918 income and does not represent investment in a new asset the reserve is reduced for purpose of invested capital.

Invested Capital for Fractional Part of Year. In the case of a corporation making a return for a full year of 12 months, its invested capital for the year is the average invested capital for the year. In the case of a corporation making a return for a fractional part of a year, its invested capital for such period is the same fractional part of the average invested capital for such period, except that for the purpose of Section 311 (a) (2) of the statute it is the full average invested capital for the period. To illustrate: A corporation was organized July 1, 1918, and makes a return for the six months ending December 31, 1918. The invested capital consists of $100,000 paid in on July 1 and $100,000 paid in on October 1. The average invested capital for such period would be

100 T. D. 2791, dated February 17, 1919; Reg. 45, Art. 845.
101 T. D. 2791.

$100,000 plus 92/184 (not 92/365) of $100,000 or $50,000, a total of $150,000. The invested capital for the period for the purpose of the tax would, however, be 184/365 of $150,000, or $75,616.44. But see Section 311 (a) (2) of the statute.[101a]

Invested Capital for Prewar Period. The invested capital for the prewar period should in general be determined in the same manner as for the taxable year.[102]

ADJUSTMENT FOR ASSET DIFFERENTLY VALUED IN PREWAR INVESTED CAPITAL. In any case in which as a result of a reorganization or for any other reason any asset in existence both during the taxable year and any prewar year is included in computing the invested capital for the taxable year, but is not included in computing the invested capital for such prewar year, or is valued on a different basis in computing the invested capital for the two years, the difference resulting therefrom shall not be included in determining the difference, 10 per cent of which is added to or deducted from the war-profits credit under Section 311 (a) (2). In any such case the corporation shall make the readjustment required by the statute, and shall submit with its return a full statement of the difference in such valuations and of the facts which give rise to such difference.[103] This provision may operate in a case where a corporation was reorganized after the beginning of the prewar period, or consolidated with another, as a result of which good will, patents or other assets owned during the prewar period may have been capitalized for the first time, or the capital value of which may have been increased.

REORGANIZATION AFTER JANUARY 1, 1911. In the case of the reorganization, consolidation or change of ownership after January 1, 1911, of a trade or business carried on during the taxable year by a corporation, the corporation shall for the purpose of determining invested capital

101a Reg. 45, Arts. 855, 856. See illustration p. 780.
102 Reg. 41, Art. 51. As to affiliated corporations see p. 771.
103 Rev. Act of 1918, § 330; Reg. 45 ,Art. 934.

or the war-profits credit be deemed to have been in existence prior to that date and the net income and invested capital of such predecessor for all or any part of the prewar period up to the organization of the corporation now carrying on such trade or business shall be deemed to have been a net income and invested capital of such corporation. If the predecessor trade or business was carried on by a partnership or individual, the corporation shall make its return of the net income and invested capital of such trade or business as nearly as may be in the same manner as if such trade or business had been carried on by a corporation. It shall submit with its return a statement setting forth (a) the manner in which such trade or business was carried on and (b) the points, if any, in which the provisions of the statute and of the regulations are not fully applicable to the determination of the net income or invested capital of the predecessor trade or business for the prewar period. In no case shall the deduction from gross income for salary or compensation for personal services exceed the salaries or compensation customarily paid at that time by corporations or partnerships of similar size and standing engaged in like or similar trades or businesses for similar services under like responsibilities.[104]

Average Invested Capital for Prewar Period. The average invested capital for the prewar period is determined by first ascertaining the average invested capital for each year during the whole of which the corporation was in existence and averaging the sums so obtained.[105]

Invested Capital of Insurance Companies. Under the 1917 Law it was held that the invested capital of a mutual insurance company would be deemed to consist of the sum of (1) any surplus or contingent reserves maintained for the general use of the business, plus (2) any legal reserves the net additions to which are included in the net income subject to the tax making due allowance for inadmissible

104 Rev. Act of 1918; Reg. 45, Art. 932.
105 Id. § 326 (d).

assets as required by the law. The invested capital of a stock insurance company was deemed to consist of its capital stock, paid-in or earned surplus and undivided profits, subject to the restrictive provisions regarding inadmissible assets, and computed in accordance with the provisions applying to the computation of invested capital of corporations.[106]

Invested Capital of Foreign Corporations. The 1917 Law provided that in the case of a foreign corporation the invested capital would be determined by taking that proportion of the entire invested capital, as defined and limited by the law, which the net income from sources within the United States bore to the entire net income.[107] As a practical matter the Treasury Department found it extremely difficult to ascertain the invested capital of foreign corporations and ruled that where upon application by a foreign taxpayer it was found that the expense of securing the data necessary for the computation of the invested capital would be unreasonable in view of the amount of tax involved, or that it was impracticable to determine either the "entire invested capital" or the "entire net income" assessment would be made under Section 210 of that law as a case in which the invested capital could not be satisfactorily determined. In the present statute it is apparently contemplated that in all cases the tax shall be assessed against foreign corporations without regard to the invested capital of the corporation but on the basis of taking the same percentage of net income of the foreign corporations from sources within the United States as the percentage taken in the case of representative domestic corporations.[108]

War-Profits Credit.[109] In the case of all domestic corporations the war-profits credit includes a specific exemption of $3,000.

[106] Reg. 41, Art. 65.
[107] Rev. Act of 1917, § 207.
[108] Rev. Act of 1918, § 327 and § 328.
[109] Rev. Act of 1918, §§ 327, 328.

MINIMUM WAR-PROFITS CREDIT. In all cases the minimum war-profits credit is an amount equal to 10% of the invested capital for the taxable year plus the specific exemption. This minimum exemption is allowed to any corporation which had no net income for the prewar period or whose net income for the prewar period was less than 10%.[109a]

WHERE INCOME IN PREWAR PERIOD WAS MORE THAN 10%. If the net income of a corporation for the prewar period was more than 10%, the average net income, determined by taking the total net income for the prewar period and dividing by the number of years during the whole of which the corporation was in existence, even though there may have been no net income for one or more of such years, shall be taken as a part of the war-profits credit. To this is added or deducted (depending upon whether or not the capital has been increased or reduced) 10% of the difference between the average invested capital for the prewar period and the invested capital for the taxable year.[109b]

CORPORATIONS WHICH HAD NO PREWAR PERIOD. If the corporation had no prewar period, the war-profits credit is the specific exemption plus an amount equal to the same percentage of the invested capital of the taxpayer for the taxable year as the average percentage of net income to invested capital, for the prewar period, of corporations engaged in a trade or business of the same general class as that conducted by the taxpayer (but not less than 10% of the invested capital of the taxpayer for the taxable year). Such average percentage is to be determined by the Commissioner on the basis of data contained in the excess-profits tax returns filed under the Revenue Act of 1917. If such average percentage has not been determined and published at least thirty days prior to the time when the return of the taxpayer is due, then the return shall be made up by using 10% as a deduction, but such average

[109a] Reg. 45, Art. 782.

[109b] See p. 774 for illustration.

percentage when determined shall be used by the Commissioner in fixing the correct amount of the tax.[110] The war-profits credit shall be computed in the first instance on the basis of 10% of the invested capital, and when the average percentage has been determined the amount of tax will be recomputed.[110a] If the majority of the stock of any corporation which had no prewar period is owned or controlled at any time during the taxable year by a corporation which had a prewar period, this provision does not apply and it seems that in such cases the intent of the law is to either limit the deduction to 10% or to compute the tax on the basis applicable to affiliated corporations.[111]

Corporations Deriving Income from Government Contracts. In the case of a corporation which had no prewar period and 50% or more of whose gross income consists of gains, profits, commissions, or other income derived from Government contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, the deduction shall be the specific exemption plus 10% of the invested capital for the taxable year.[112]

Foreign Corporations. A foreign corporation is allowed the same war-profits credit as a domestic corporation except that it is not entitled to the specific exemption of $3,000.[113]

Excess-Profits Credit. The excess-profits credit in the case of a domestic corporation consists of the specific ex-

110 Rev. Act of 1918, § 311 (c).

110a Reg. 45, Art. 783.

111 Rev. Act of 1918, § 311 (d); Reg. 45, Art. 784.

112 Id. It should be noted that this provision applies to all corporations which had no pre-war period and one-half of whose income is derived from Government contracts or subcontracts (as defined in Section 1 of the 1918 Law—see p. 708. In Section 327 of the law, the restriction is limited to cases where the Government contracts provided for payment on a cost-plus basis. See p. 763.

113 Id. Section 311 (e) Section 327, however, provides that foreign corporations shall be taxed on the showing of representative corporations and not on the basis of their own invested capital.

emption of $3,000 plus an amount equal to 8% of the invested capital for the taxable year. In the case of a foreign corporation the excess-profits credit is the same except that it does not include the specific exemption of $3,000.[114]

Specific Exemption. Every corporation is allowed a specific exemption of $3,000 to be deducted from the net income, but if the tax is computed for a period of less than twelve months the specific exemption is reduced in proportion.[115] The specific exemption of $3,000 is apportioned only in the case where a return is made covering a period of less than twelve months. In such a case the specific exemption is the same proportion of $3,000 as the number of months in the period is of twelve months, any part of a month being counted as a month. Thus, in the case of a corporation organized June 16, 1918, and making a return for the period ending December 31, 1918, the exemption is 7/12 of $3,000, or $1,750. This provision is inapplicable where the return is made for a full fiscal year beginning prior to January 1, 1918, and ending after that date, even though the income for such fiscal year is not subject to full taxation under the present statute. In the case of affiliated corporation only one specific exemption is allowed.[115a]

Net Income. Net income for this tax is ascertained in general upon the same basis and in the same manner as for the purpose of the income tax except as follows:

FOR THE YEARS 1911 AND 1912. The net income for these years is determined upon the same basis and in the same manner as provided in the 1909 Corporation Excise Tax Law except that the tax as imposed by that law and paid by the corporation within the year shall be included. Including such taxes for the years 1911 and 1912 is a slight advantage to the corporation in that it increases

114 Id. § 312.
115 Id. § 305.
115a Reg. 45, Arts. 761, 785.

the net income for the prewar period for the purpose of the war-profits credit.[116]

FOR THE YEAR 1913. The net income for the year 1913 is ascertained on the same basis and in the same manner as provided in the 1913 Law except that the taxes imposed on the corporation on its income for 1912 and paid by the corporation in 1913 may be included, and the amount received by it as dividends must be deducted.[117]

AVERAGE NET INCOME FOR THE PREWAR PERIOD. The average net income for the prewar period is determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the net income for such years, even though there may have been no net income for one or more of such years.[118] Thus, if a corporation was in existence during 1912 and 1913 but derived no income in 1912, its income for the year 1913 must be divided by two in order to ascertain the war-profits credit. But on the other hand, if the corporation had a deficit for the year 1912 and income for the year 1913, the amount of the deficit need not be deducted from the net income of 1913 in order to ascertain the average net income for the prewar period.[119] As to the prewar income of affiliated corporations, see below.[119a]

FOR THE TAXABLE YEAR. Net income for the taxable year is computed upon the same basis and in the same manner as provided for income tax purposes under the income tax law.[120] The law expressly provides that the net income of a corporation which is subject to the income tax shall also be subject to the excess-profits tax. This would include income derived as a gain from the sale of the capital assets of the taxpayer,[121] but in the case of the

116 Rev. Act of 1918, § 320 (a).

117 Id.

118 Id. § 320 (b).

119 Letter from Treasury Department dated February 21, 1918.

119a See p. 772.

120 Rev. Act of 1918, § 320 (a).

121 Letter from Treasury Department dated February 21, 1918.

sale of mines, oil and gas wells a limitation is placed upon the amount of the excess-profits tax to be assessed with respect thereto as more fully stated in a preceding paragraph.[122] Under the 1917 Law the net income for purpose of income tax and excess-profits tax were not identical, since for the purpose of the latter tax corporations were expressly allowed to deduct dividends. Since the 1917 Law provided an excess-profits tax at lower rates on salaries than on income from a business employing invested capital the Treasury Department held that where a corporation had paid its officers only nominal salaries, a reasonable allowance for salaries could be deducted for any period prior to March 1, 1918, if a satisfactory explanation was given.[123] Under the present law there seems to be no need for a ruling of this character since an excess-profits tax law has been in force for a length of time sufficient to enable corporations to adjust salaries and other items which in the past may have been merely nominal by reason of the relation of the corporation to its stockholders.

Assessment Without Reference to Invested Capital. In certain cases it is found difficult or impossible to determine the invested capital of a corporation. In such cases the tax is to be computed on the basis of the returns of representative corporations.[124] Four cases are enum-

122 See p. 715.

123 Letter from Treasury Department dated March 11, 1918.

124 Rev. Act of 1918, § 327. This section of the 1918 Law corresponds to the famous Section 210 of the 1917 Law which provided that when the invested capital could not be satisfactorily determined the corporation was entitled to an excess-profits deduction of an amount equal to the same proportion of its net income for the taxable year as the average deduction (excluding the specific sum of $3,000) for the corresponding year of representative corporations plus the sum of $3,000. In determining this proportion the net incomes of representative corporations for the calendar year or for fiscal years ending in the calendar year were taken. In case the corporation whose invested capital could not be satisfactorily determined made a return for its own fiscal year the proportion determined for the calendar year ending during such fiscal year was used. (Reg. 41, Art. 24.) The rulings provided for a computation

erated in the law in which the tax shall be determined without reference to the invested capital of the taxpayer. These cases are discussed in the following paragraphs.

Where Commissioner Is Unable to Determine Invested Capital. The first case is where the Commissioner is unable to determine the invested capital as provided in Section 326 of the law. Such cases exist, for example, where the books of account of the company have not been kept in proper form or where it is impossible to ascertain the values of the assets at the time of acquisition.[125]

In the Case of Foreign Corporations. The law provides that the tax shall be determined without reference to invested capital in the case of a foreign corporation. It is likely that the Treasury Department will continue its ruling under the 1917 Law to the effect that assessment will be made without reference to invested capital in cases where it is found that the expense of securing the data necessary for the computation of the invested capital would be unreasonable in view of the amount of tax involved, or that it is impracticable to determine either the entire invested capital or the entire net income of the foreign corporation. In the case of a foreign corporation carrying on all of its business in the United States it does not seem that the law should prevent the corporation from obtaining such benefits as may accrue to it from a computation of the taxes based on its invested capital in the manner prescribed in Section 326 of the Law, but the language of this provision seems to indicate an intent that

of constructive invested capital in order to apply the rates to a corporation whose invested capital could not be determined. (Reg. 41, Art. 18.) Under the present law there is no need for constructive capital in such cases since the tax is now based upon the ratio of the amount of tax to the amount of net income of representative corporations.

125 The 1917 Law (Section 210) provided a method which should be followed in all cases in which the Commissioner was unable *satisfactorily* to determine the invested capital. In the language of the present law the word "satisfactorily" was omitted.

this method of assessment shall apply to all foreign corporations.[126]

Where Stock Has Been Issued for a Mixed Aggregate of Tangible and Intangible Property. This provision of the law does not apply in all cases where a mixed aggregate of tangible and intangible property has been paid in for stock or for stock and bonds, but only in such cases where the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds respectively. Under the 1917 Law it was ruled that assessment would be made under section 210 of that law in cases where the Secretary was unable to determine satisfactorily the respective values of the several classes of property at the time of payment.[127] This provision of the law seems to be a statutory declaration of the rule adopted by the Treasury Department as a matter of practice.

Cases of Abnormal Conditions Affecting Capital or Income. In these cases assessment without reference to invested capital is intended to operate as a remedial measure. Such assessment is made only upon application by the corporation in cases where, upon such application, the Commissioner finds (and so declares of record) that the tax if determined without the benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without the benefit of this section and the tax computed by reference to representative corporations. This provision does not apply to any case (1) in which the tax based upon the corporation's invested capital is high merely because the corporation earned a high rate of profits upon a normal invested capital nor (2) in which 50% or more of the gross income of the corporation for the taxable year consists of gains, profits,

126 Rev. Act of 1918, § 327.

127 Reg. 41, Art. 52.

commissions or other income derived *on a cost plus basis* from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.[128] The tax will not ordinarily be assessed under this provision of law merely because the corporation's form or manner of organization, or the limitations as to invested capital result in a greater tax than would otherwise be payable. A corporation which comes within the provisions of subdivision (d) of section 327 may make application for assessment under the provisions of section 328, which ap-

[128] Rev. Act of 1918, § 328 (d). Under the 1917 Law the following were held to be exceptional cases which warranted assessment under Section 210 of that law.

(1) Where, through defective accounting or lack of adequate data, it was impossible accurately to compute invested capital.

(2) Where upon application by a foreign taxpayer the Secretary of the Treasury found that the expense of securing the data necessary for the computation of the invested capital would be unreasonable in view of the amount of tax involved, or that it was impracticable to determine either the "entire invested capital" or the "entire net income."

(3) Long established business concerns which by reason of ultraconservative accounting or the form and manner of their organization would otherwise be placed at a serious disadvantage in competing with representative concerns in a like or similar trade or business.

(4) Where the invested capital was seriously disproportioned to the taxable income. Such cases it was held might arise through (a) the realization in one year of the earnings of capital unproductively invested during a period of years or the fruits of activities antedating the taxable year; or (b) inability to recognize or properly allow for amortization, obsolescence, or exceptional depreciation due to the war, or to the necessity in connection with the war of providing plant which would not be wanted for the purposes of the business after the termination of the war. (Reg. 41, Art. 52.)

Under the present law the conditions described in 1 and 2 are expressly provided for; 3 and 4 (a) will probably be considered as creating "abnormal conditions affecting the capital or income" within the meaning of Section 327 (d) and therefore entitle the corporation to relief. The condition stated in 4 (b) no longer exists as the present law enables the taxpayer to recognize and properly allow for amortization, obsolescence or exceptional depreciation. (Reg. 41, Art. 52.)

plication shall be attached to its return in the form of a statement setting forth in full: (a) the reasons why the tax should be so determined; (b) the facts upon which such reasons are based; (c) an exact description of each trade or business or important branch of a trade or business carried on by it; (d) a statement of the invested capital and net income for each year since the beginning of the prewar period; and (e) a statement showing the amount of gains, profits, commissions or other income derived on a cost plus basis from Government contracts made after April 5, 1917, and before November 12, 1918, and showing the per cent which such income is of the total income of the corporation.[128a]

Method of Assessment. Under this method of assessment, the tax shall be an amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation the tax is computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.[129] Illustrations: If the average net income of representative corporations is represented by $100,000, the net income in excess of the specific exemption would be $97,000. If the average tax is found to be $38,800, the rate to be applied to domestic corporations will be 38,800 ÷ 97,000 or 40%. Thus, a domestic corporation having a net income of $60,000 will deduct the specific exemption of $3,000, leaving $57,000—40% of which is $22,800, the amount of tax due under this section. But if the corporation is a foreign corporation and has an income of $60,000 the tax rate will be determined by divid-

[128a] Reg. 45, Art. 901.

[129] Rev. Act of 1918, § 328 (a). This method is much simpler than that prescribed by Section 210 of the 1917 Law and reaches approximately the same result.

ing 38,800 by 100,000 which decreases the percentage to 38.8%. But this is applied to the entire net income, $60,000, making the tax due from the foreign corporation $23,280, or $480 more than that imposed on a domestic corporation with the same net income.

Representative Corporations. The representative corporations with respect to which the tax is to be computed under this section are those corporations whose invested capital can be satisfactorily determined under Section 326 of the law and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war-profits or excess-profits, and all other relevant facts and circumstances.[130] In each case the Commissioner will determine, as nearly as may be, the group or class of corporations with which the corporation should be compared.[130a]

Ratio Between Average Tax and Average Net Income. The ratios between the average tax and the average net income of representative corporations is to be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.[131]

Payment of Tax by Corporations Applying for This Assessment. In cases in which the tax is to be computed without reference to the invested capital, the corporation is required to pay its tax in installments without the benefit of the section, if the tax as so computed is less than 50% of the net income of the taxpayer. But if the tax so computed is 50% or more of the net income the installments to be paid by the corporation shall in the first instance be computed upon the basis of a tax equal to 50%

130 Rev. Act of 1918, § 328 (a). The present law does not require that the representative corporation shall be "engaged in a like or similar trade or business" as did the 1917 Law, a requirement which caused much difficulty in the assessment of the 1917 tax as many corporations claimed no others were engaged in any trade or business like or similar to theirs.

130a Reg. 45, Art. 911.

131 Rev. Act of 1918, § 328 (b).

of the net income. In any case, the actual ratio when ascertained shall be used in determining the correct amount of the tax. If the correct amount of the tax when determined exceeds 50% of the net income any excess of the correct installments over the amounts actually paid shall become due on notice and demand together with interest at the rate of one-half of one per cent. per month on such excess from the time the installment was due. If on the other hand the correct determination of the amount of the tax is less than the amount on which installments have been paid the law impliedly provides that the amount so paid shall either be credited to the installments falling due after final determination, or if all the installments have been paid before the tax is finally determined the amount shall be refunded in the usual manner.[132] No interest however will be paid to the taxpayer on excess amounts paid in the first instance.

Commissioner to Keep Record. The Commissioner is required to keep a record of all cases in which the tax is determined without reference to invested capital containing the name and address of the taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return. The law also requires this record to show the amount of invested capital as determined under subdivision (a) of Section 328, but that subdivision does not call for a determination of invested capital and hence this last requirement is meaningless. The Commissioner is required to furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress without regard to the restrictions usually imposed upon him with respect to divulging information contained in income tax returns.[133]

Incorporation of Business of Partnership or Individual. In the case of the organization as a corporation before July 1, 1919, of any business in which capital is a ma-

[132] Id. § 328.
[133] Id. § 328 (c).

terial income-producing factor and which was previously owned by a partnership or individual the net income of such trade or business from January 1, 1918, to the date of such reorganization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed for income tax, excess-profits and war-profits tax purposes. If the individual or partnership chooses to adopt this method of taxation the net income and invested capital shall be computed as if the corporation had been in existence on and after January 1, 1918, and in such cases (1) amounts distributed on or after January 1, 1918, from the earnings shall be taxed to the recipients as dividends; (2) all the provisions of the income tax and the war-profits and excess-profits tax sections of the law relating to corporations shall so far as practicable be applied to such trade or business; (3) the trade or business shall be subject to the capital stock tax imposed by Section 407 of the Revenue Act of 1917 and Section 1000 of the Revenue Act of 1918 as if such taxpayer had been a corporation on and after January 1, 1918, with a capital stock having no par value; (4) the undistributed profits or earnings of such taxpayer shall not be subject to the surtax imposed by Section 211 of the Income Tax Law; (5) this option to be taxed as a corporation shall not apply to any trade or business the net income of which for the taxable year 1918 was less than 20% of its invested capital for such year.[134]

Affiliated Corporations. The invested capital of affiliated corporations[135] for the taxable year is the invested capital of the entire group treated as one unit operated under a common control. As a first step in the computation a consolidated balance sheet should be prepared in accordance with standard accounting practices, which will reflect the actual assets and liabilities of the affiliated group. In preparing such a balance sheet all intercompany items, such as intercompany notes and accounts receivable

[134] Id. § 330; Reg. 45, Art. 933.

[135] See Chapter 12, Page 223.

and payable, should be eliminated from the assets and the liabilities, respectively, and proper adjustments should be made in respect of intercompany profits or losses reflected in inventories which at the beginning or end of the taxable year contain merchandise exchanged between the corporations included in the affiliated group at prices above or below cost to the producing or original owner corporation. Such consolidated balance sheet will then show (a) the capital stock of the parent or principal company in the hands of the public; (b) the consolidated surplus belonging to the stockholders of the parent or principal company; and (c) the capital stock, if any, of subsidiary companies not owned by the parent or principal company, together with the surplus, if any, belonging to such minority interest. In computing consolidated invested capital the starting point is furnished by the total of the amounts shown under (a), (b) and (c) above. This total must be increased or diminished by any adjustments required to be made under the provisions relating to invested capital.[135a]

INTANGIBLE PROPERTY PAID IN. (1) In respect of corporations whose affiliation is in the nature of parent and subsidiary companies: (a) in the case of intangible property bona fide paid in for stock or shares prior to March 3, 1917, there may be included in invested capital an amount not exceeding the actual cash value of such property at the time paid in or the par value of the stock or shares issued therefor, or in the aggregate 25 per cent of the par value of the total stock or shares of the consolidation outstanding on March 3, 1917 (determined as indicated in items (a) and (c) of the preceding paragraph), or in the aggregate 25 per cent of the par value of the total stock or shares shown on the consolidated balance sheet, being the amount of the capital stock included in items (a) and (c) in the preceding paragraph, at the beginning of the taxable year, whichever is lowest; and (b) in the case of intangible property bona fide paid in for stock or shares on or after March

[135a] Reg. 45, Art. 864.

3, 1917, there may be included in invested capital an amount not exceeding the actual cash value of such property at the time paid in, or the par value of the stock or shares issued therefor, or in the aggregate 25 per cent of the par value of the total stock or shares shown by the consolidated balance sheet, being the amount of the capital stock included in items (a) and (c) in the preceding paragraph outstanding at the beginning of the taxable year, whichever is lowest. (c) When intangible property has been acquired in part before and in part after March 3, 1917, the amounts shall be ascertained, respectively, under (a) and (b) above and in the aggregate shall in no case exceed 25 per cent of the par value of the total stock or shares outstanding at the beginning of the taxable year shown in the consolidated balance sheet, being the amount of the capital stock included in items (a) and (c) in the preceding paragraph. (2) In respect of corporations affiliated by reason of ownership by the same interests, the limitations set forth in paragraphs (4) and (5) of subdivision (a) of Section 326 of the statute shall be applied to each corporation separately and the aggregate of the intangible property, so valued, shall be included in invested capital in the consolidated return. In respect of each of the affiliated corporations the aggregate of the amounts ascertained under the provisions of paragraphs (4) and (5) shall in no case exceed 25 per cent of the outstanding capital stock of such corporation at the beginning of the taxable year.[135b]

INADMISSIBLE ASSETS. Where adjustment is required in respect of inadmissible assets in accordance with the provisions of subdivision (c) of Section 326 of the statute, such adjustment shall be made on the basis of the consolidated balance sheet with due regard to the adjustments and eliminations set forth in the preceding paragraphs and the general provisions relating to inadmissible assets.[135c]

STOCK OF SUBSIDIARY ACQUIRED FOR CASH. When all or

135b Id., Art. 865.

135c Id., Art. 866. See p. 737.

substantially all of the stock of a subsidiary corporation was acquired for cash, the cash so paid shall be the basis to be used in determining the value of the property acquired.[136]

STOCK OF SUBSIDIARY ACQUIRED FOR STOCK. When substantially all the stock of a subsidiary corporation was acquired with the stock of the parent corporation, the amount to be included in the consolidated invested capital in respect of the corporation acquired shall be the actual cash value of the stock of the subsidiary corporation at the date or dates acquired, measured by the cash value of its net assets at such date or dates (the cash value of tangible and intangible assets being separately determined), but limited to the par value of the stock of the parent corporation issued therefor, or if the stock of the parent corporation has no par value, then limited to the value of such non-par value stock ascertained in accordance with the provisions of Section 325 (b) of the statute. If in connection with such acquisition a paid-in surplus is claimed, such claim will be subject to the provisions relating to paid-in surplus generally.[136a]

INVESTED CAPITAL FOR PREWAR PERIOD. The invested capital of affiliated corporations for the prewar period shall be computed on the same basis as the invested capital for the taxable year, except that where any one or more of the corporations included in the consolidation for the taxable year were in existence during the prewar period, but were not then affiliated as herein defined, then the average consolidated invested capital for the prewar period shall be the average invested capital of the affiliated corporations plus the average invested capital of the corporations not affiliated during the prewar period. Full recognition, however, must be given to the provisions of section 330 of the statute, particularly the last paragraph thereof, and of the regulations issued thereunder.[136b]

136 Id., Art. 867.
136a Id., Art. 868.
136b Id., Art. 869. See pp. 745 and 754.

PREWAR NET INCOME OF AFFILIATED CORPORATIONS. The consolidated net income of affiliated corporations for the prewar period shall be the aggregate of the average net income for the prewar years of such of the several corporations included in the consolidation for the taxable year, whether or not affiliated during such prewar period, as were in existence during all of the prewar period or during at least one full year of the prewar period.[136c]

Balance Sheet. With respect to the taxable year 1917 every corporation was required to submit a balance sheet as at the first day of the taxable year and also a balance sheet as at the close of the taxable year. It was also ruled that thereafter only the balance sheet as at the close of each taxable year would be required. Balance sheets were required to be made in accordance with the books of the taxpayer and changes in respect of any items therein made pursuant to the regulations were to be explained in a separate statement attached to the balance sheet to which it related.[137]

Returns. Every corporation having an income of $3,000 or over for the taxable year is required to make a return unless it is one of the exempt corporations enumerated in the Income Tax Law.[138] Whenever the net income of the corporation is $3,000 or over a return will be required regardless of the fact that the deduction to which the corporation is entitled may reduce the taxable net income to nothing.[139] Such returns shall be made at the same times and places, in the same manner and subject to the same conditions, as is provided in the case of returns of income tax by corporations. Extensions of time for filing the excess-profits tax returns may be granted by the Commissioner to the same extent as they may be granted in the case of income tax returns.

136c Id., Art. 802.

137 Reg. 41, Art. 53.

138 Rev. Act of 1918, § 336. As to exempt corporations see Chapter 15.

139 Letter from Treasury Department dated March 22, 1918.

Return of Prewar Data. Under the 1917 Law it was held that a return of information as to invested capital and net income for the prewar period would not be required if the taxpayer accepted the minimum percentage of 7% as a deduction.[140] There seems to be no reason why the Treasury Department should not rule with respect to the 1918 Law that no information regarding prewar invested capital and prewar net income will be required if the corporation accepts the minimum war-profits credit of 10% on the invested capital for the taxable year.

Time and Manner of Paying Tax. The war-profits and excess-profits taxes are to be paid at the same times and places, in the same manner, and subject to the same conditions, as is provided in the case of payments of income tax; that is the tax shall be paid in installments on the dates specified with reference to the income tax.[141]

Penalties. All the provisions of the income tax law not inapplicable, including the provisions relating to penalties are made applicable to the filing of returns and payment of war-profits and excess-profits taxes.[142]

Administrative Provisions. In general the administrative provisions applicable to the income tax law are also applicable to the administration of the war-profits and excess-profits tax law.[143]

140 T. D. 2614.

141 Rev. Act of 1918. § 336. As to the time and manner of paying income taxes see Chapter 35.

142 Rev. Act of 1918, § 336.

143 Id.

APPENDIX TO CHAPTER 45

ILLUSTRATIONS OF COMPUTATIONS OF THE TAX

No. 1. Illustration of Ordinary Computation of Tax. A corporation has an average prewar invested capital of $50,000, an average prewar net income of $10,000, an invested capital for 1918 of $100,000, a net income for 1918 of $40,000, an invested capital for 1919 of $110,000, and a net income of $50,000.

(1) For 1918 the excess-profits credit is a specific exemption of $3,000, plus 8 per cent of the invested capital (i. e., 8 per cent of $100,000) or $8,000, making a total of $11,000. The war profits credit is a specific exemption of $3,000, plus the average prewar net income or $10,000, plus or minus 10 per cent of the difference between the average prewar invested capital and the invested capital for 1918. In this case it is plus, because the invested capital for 1918 is greater than the average prewar invested capital. The amount added is 10 per cent of the difference between $100,000 and $50,000, i. e., 10 per cent of $50,000, or $5,000, making a total war-profits credit of $18,000.

First Bracket. The amount or portion of the net income ($40,000) in excess of the excess-profits credit ($11,000) and not in excess of 20 per cent of the invested capital (i. e., 20 per cent of $100,000) or $20,000 is $9,000. The tax computed under this bracket is 30 per cent of this amount (i. e., 30 per cent of $9,000) or $2,700.

Second Bracket. The amount or portion of the net income ($40,000) in excess of 20 per cent of the invested capital (i. e., 20 per cent of $100,000) or $20,000 is $20,000. The tax computed under this bracket is 65 per cent of this amount (i. e., 65 per cent of $20,000) or $13,000.

Third Bracket. Eighty per cent of the amount or portion of the net income in excess of the war-profits credit (i. e., 80 per cent of the amount by which $40,000 exceeds $18,000, or $22,000) is $17,600. The amount of the tax computed under the first and second brackets ($2,700 plus $13,000) is $15,700. The tax computed under this bracket is the amount by which $17,600 exceeds $15,700, or $1,900.

Total Tax. The total tax for 1918 is the sum of the taxes computed under the three brackets (i. e., $2,700 plus $13,000 plus $1,900) or $17,600.

(2) For 1919 the excess-profits credit is a specific exemption of

$3,000 plus 8 per cent of the invested capital (i. e., 8 per cent of $110,000) or $8,800, a total of $11,800.

FIRST BRACKET. The amount or portion of the net income ($50,000) in excess of the excess-profits credit ($11,800) and not in excess of 20 per cent of the invested capital (i. e., 20 per cent of $110,000) or $22,000 is $10,200. The tax computed under this bracket is 20 per cent of this amount (i. e., 20 per cent of $10,200) or $2,040.

SECOND BRACKET. The amount or portion of the net income ($50,000) in excess of 20 per cent of the invested capital (i. e., 20 per cent of $110,000) or $22,000 is $28,000. The tax computed under this bracket is 40 per cent of this amount (i. e., 40 per cent of $28,000) or $11,200.

TOTAL TAX. The total tax for 1919 is the sum of the taxes computed under the two bracket (i. e., $2,040 plus $11,200) or $13,240.

No. 2. Illustration of Computation Where No Tax Under Third Bracket. If the corporation used in the foregoing illustration had an average prewar net income of $20,000 instead of $10,000, the excess-profits credit and the tax for 1918 computed under the first and second brackets would be the same, but the war-profits credit and the tax computed under the third bracket would not be the same. The war-profits credit would be a specific exemption of $3,000 plus .the average prewar net income or $20,000, plus 10 per cent of $50,000 (the difference in invested capital) or $5,000, making a total war-profits credit of $28,000.

THIRD BRACKET. Eighty per cent of the amount of the net income in excess of the war profits (i. e., 80 per cent of the amount by which $40,000 exceeds $28,000 or 80 per cent of $12,000) is $9,600. The amount of the tax computed under the first and second brackets ($2,700 plus $13,000) is $15,700. There is accordingly no tax under the third bracket, as $9,600 does not exceed $15,700.

TOTAL TAX. The total tax for 1918 is the sum of the taxes computed under the three brackets (i. e., $2,700 plus $13,000 plus nothing) or $15,700. The total tax of 1919 would, of course, be the same as in the foregoing illustration.

No. 3. Illustration of Computation Where Excess Profits Credit Not Exhausted Under First Bracket. A corporation has an average prewar invested capital of $20,000, an average prewar net income of $7,000, and invested capital and net income for 1918 of the same amounts, respectively. The excess-profits credit is a specific exemption of $3,000 plus 8 per cent of the invested capital (i. e., 8 per cent of $20,000) or $1,600, a total of $4,600. The war-

profits credit is a specific exemption of $3,000 plus the average prewar net income of $7,000, a total of $10,000. There is nothing further to be added or deducted in this case, as there is no difference between the average invested capital for the prewar period and invested capital for the taxable year.

FIRST BRACKET. The excess-profits credit ($4,600) exceeds 20 per cent of the invested capital (20 per cent of $20,000) or $4,000, and there is no amount taxable under this bracket.

SECOND BRACKET. The portion of the net income ($7,000) in excess of 20 per cent of the invested capital (20 per cent of $20,000) or $4,000 is $3,000. In this case, however, the full amount of the excess-profits credit could not be allowed under the first bracket, so that the $3,000 which would ordinarily be taxable under this bracket is reduced by the amount of the excess-profits credit not allowed under the first bracket ($600), leaving only $2,400 taxable under this bracket. The tax computed under this bracket is 65 per cent of this amount (i. e., 65 per cent of $2,400) or $1,560.

THIRD BRACKET. The war-profits credit ($10,000) exceeds the net income ($7,000), so that there is no tax under this bracket.

TOTAL TAX. The total tax for 1918 would be the sum of the taxes computed under the three brackets (i. e., nothing plus $1,560 plus nothing) or $1,560, were it not that Section 302 provides that the maximum tax shall not in this case exceed $1,200. The total tax for 1918 is therefore $1,200. (See illustration No. 10.)

No. 4. Illustration of Computation Where Net Income Derived from Government Contract. If in the case used in illustration No. 1 the $50,000 net income for 1919 includes $20,000 of net income from Government contracts, the tax for that year would be the sum of the amounts computed under clauses (1) and (2) of Section 301 (c) of the statute.

(1) Under clause (1) the excess-profits credit is $11,800, the same as under clause (2). The war-profits credit is a specific exemption of $3,000, plus the average prewar net income, or $10,000, plus 10 per cent of $50,000 (the difference in invested capital) or $6,000, making a total war-profits credit of $19,000.

FIRST BRACKET. The amount or portion of the net income ($50,000) in excess of the excess-profits credit ($11,800) and not in excess of 20 per cent of the invested capital (i. e., 20 per cent of $110,000), or $22,000, is $10,200. The tax computed under this bracket is 30 per cent of this amount (i. e., 30 per cent of $10,200) or $3,060.

SECOND BRACKET. The amount or portion of the net income ($50,000) in excess of 20 per cent of the invested capital (i. e.,

20 per cent of $110,000) or $22,000, is $28,000. The tax computed under this bracket is 65 per cent of this amount (65 per cent of $28,000) or $18,200.

THIRD BRACKET. Eighty per cent of the amount of the net income in excess of the war-profits credit (i. e., 80 per cent of the amount by which $50,000 exceeds $19,000, or $31,000) is $24,800. The amount of the tax computed under the first and second brackets ($3,060 plus $18,200) is $21,260. The tax computed under this bracket is the amount by which $24,800 exceeds $21,260, or $3,540.

The portion of the tax computed under clause (1) is the same proportion of the total amount computed under the above brackets at the rates for 1918 (i. e., $3,060 plus $18,200 plus $3,540) or $24,800, as the part of the net income attributable to Government contracts ($20,000) is of the entire net income ($50,000). This portion of the tax is therefore 2/5 of $24,800 or $9,920.

(2) The portion of the tax computed under clause (2) is the same proportion of the total amount computed at the rates for 1919 or $13,240 (for the details see computation for 1919 in illustration No. 1 above) as the part of the net income not attributable to Government contracts ($30,000) is of the entire net income ($50,000). This portion of the tax is therefore 3/5 of $13,240 or $7,944.

(3) The total tax for the year 1919 is the sum of the amounts computed under paragraphs (1) and (2) above ($9,920 plus $7,944) or $17,864.

No. 5. Illustration of Computation of Tax Where Net Income Is Partly from Personal-Service Business. A corporation is engaged in contracting and construction work (a non-personal service business in which the employment of capital is necessary) and also renders consulting engineering service (a personal-service business which if constituting its sole business would bring it within the class of personal-service corporations). It has an average prewar invested capital of $50,000 (of which $38,000 was used in contracting work and $12,000 in engineering); an average prewar net income of $52,000 (of which $12,000 was derived from contracting and $40,000 from engineering); invested capital for 1918 of $100,000 (of which $81,000 is used in contracting and $19,000 in engineering); and a net income for 1918 of $90,000 (of which $30,000 is derived from contracting and $60,000 from engineering).

(1) In computing the tax upon the first or non-personal-service part of the net income (i. e., $30,000 derived from contracting) the specific exemption is $1,000 (i. e., the same proportion of $3,000 which $30,000 is of the entire net income of $90,000). The

excess-profits credit is a specific exemption of $1,000, plus 8 per cent of the invested capital used in contracting (i. e., 8 per cent of $81,000) or $6,480, a total of $7,480. The war-profits credit is a specific exemption of $1,000, plus the average prewar net income derived from contracting or $12,000, plus 10 per cent of $43,000 (the difference in invested capital used in contracting) or $4,300, making a total of $17,300.

FIRST BRACKET. The amount of the net income derived from contracting ($30,000) in excess of the excess-profits credit ($7,480) and not in excess of 20 per cent of the invested capital (i. e., 20 per cent of $81,000) or $16,200 is $8,720. The tax under this bracket is 30 per cent of this amount (i. e., 30 per cent of $8,720) or $2,616.

SECOND BRACKET. The amount of the net income derived from contracting ($30,000) in excess of 20 per cent of the invested capital used in contracting (i. e., 20 per cent of $81,000) or $16,200 is $13,800. The tax computed under this bracket is 65 per cent of this amount (65 per cent of $13,800) or $8,970.

THIRD BRACKET. Eighty per cent of the amount of the net income derived from contracting in excess of the war-profits credit (i. e., 80 per cent of the amount by which $30,000 exceeds $17,300 or 80 per cent of $12,700) is $10,160. The amount of the tax computed under the first and second brackets ($2,616 plus $8,970) is $11,586. There is no tax under this bracket, as $10,160 does not exceed $11,586.

TAX. The tax upon the first portion of the net income (i. e., $30,000 derived from contracting) is the sum of the taxes computed under the three brackets (i. e., $2,616 plus $8,970 plus nothing) or $11,586. This is 38.62 per cent of $30,000 of the net income from contracting.

(2) The tax upon the second or personal-service part of the net income (i. e., $60,000 derived from engineering is the same percentage of such part of the net income (i. e., 38.62 per cent of $60,000) or $23,172.

(3) The total tax is the sum of $11,586 (the tax upon the first part of the net income derived from contracting) and $23,172 (the tax upon the second part of the net income derived from engineering) or $34,758.

No. 6. Illustration of Computation of Tax Where Net Income Is from Gold Mining. In the case used in illustration No. 1, assume the corporation is engaged in the mining both of gold and of other rare metals; that the Commissioner finds that $35,000 of its gross income is properly attributable to the mining of gold; and

that $20,000 of the deductions allowed are properly applicable to the gross income from that source. The portion of the net income attributable to the mining of gold and exempt from tax would be $15,000. The remaining portion of the net income is $25,000 and the tax thereon is the same proportion of the tax computed on the entire net income without the benefit of the exemption (i. e., a tax of $17,600) which the remaining portion of the net income ($25,000) bears to the entire net income ($40,000). The tax will therefore be 5/8 of the tax of $17,600 computed without the benefit of the exemption, or $11,000.

No. 7. Illustration of Computation of Tax Where Income from Sale of Mineral Deposit. In the case used in illustration No. 1, assume the gross income of the corporation for 1918 included $15,000 derived from a bona fide sale of an oil well, the principal value of which had been demonstrated by exploration and discovery work done by the corporation, and that the Commissioner finds that only $800 of the deductions allowed are properly applicable to the gross income derived from the sale. The portion of the net income attributable to the sale would be $14,200, which is 35.5 per cent of the entire net income of $40,000, and the portion of the tax for that year attributable to the sale will be 35.5 per cent of the entire tax of $17,600, or $6,248. But this portion of the tax can not exceed 20 per cent of the selling price ($15,000) and is accordingly reduced to $3,000. The total tax will be $11,352 (the portion of the tax not affected) plus $3,000, or $14,352 (instead of $17,600).

No. 8. Illustration of Computation of Tax for Fiscal Year. A corporation makes its return on the basis of a fiscal year ending March 31. It had an average prewar invested capital of $50,000 and an average prewar net income of $3,500. For the fiscal year ending March 31, 1918, its invested capital and net income are $100,000 and $75,000, respectively, as computed under Title II of the Revenue Act of 1917, and $125,000 and $70,000, respectively, as computed under the present statute. Such a difference in these amounts as computed under the two acts may readily occur where, for example, a corporation is allowed under the present statute a deduction for interest, amortization, etc., which it was not allowed under the Revenue Act of 1917, or where, under the present statute, it is allowed a greater amount of invested capital on account of intangible property paid in for stock or shares than allowed under the Revenue Act of 1917. For the fiscal year ending March 31, 1919, its invested capital and net income are $125,000 and $60,000, respectively.

(1) A war excess-profits tax for the year ending March 31, 1918, as computed under the provisions of Title II of the Revenue Act of 1917, and upon the basis of an invested capital of $100,000 and a net income of $75,000 as computed under that Act, is $32,800. A war-profits and excess-profits tax for the entire period as computed under subdivision (a) of Section 301 of the present statute, and upon the basis of an invested capital of $125,000 and a net income of $70,000 as computed under the statute, is $43,600. Section 335 provides that the tax for this period is the sum of 275/365 of the tax of $32,800 as computed under the Revenue Act of 1917 or $24,712.33, plus 90/365 of the tax of $43,600 as computed under the present statute or $10,750.68, making a total war excess-profits tax for the fiscal year ending March 31, 1918, of $35,463.01.

(2) A war-profits and excess-profits tax for the year ending March 31, 1919, as computed under subdivision (a) of Section 301 of the statute is $35,600. A war-profits and excess-profits tax for the entire period as computed under subdivision (b) of Section 301 is $16,400. Section 335 provides that the tax for this period is the sum of 275/365 of the tax of $35,600, as computed under subdivision (a) of Section 301, or $26,821.92, plus 90/365 of the tax of 16,400, as computed under subdivision (b) of Section 301 or $4,043.84, making a total war-profits and excess-profits tax for the fiscal year ending March 31, 1919, of $30,865.76.

No. 9. Illustration of Computation Where Return for Period of Less Than 12 Months. A corporation which has reported on the basis of the fiscal year ending March 31, 1918, later changes to a calendar year basis and files a return covering the 9 months from April 1, 1918, to December 31, 1918. It had an average prewar capital of $50,000, an average prewar net income of $3,500, an invested capital for the 9 months ending December 31, 1918, of $120,000, and a net income for such period of $50,000. Under the provisions of Section 326 (d) of the statute the invested capital to be used for the taxable period would, except for the purposes of Section 311 (a) (2), be 275/365 of $120,000 or $90,410.96. Under the provisions of Section 305 the specific exemption of $3,000 is reduced to 9/12 of $3,000 or $2,250. The excess-profits credit is a specific exemption of $2,250, plus 8 per cent of the invested capital (i. e., 8 per cent of $90,410.96) or $7,232.88, a total of $9,482.88. The war-profits credit is a specific exemption of $2,250 plus 10 per cent of the invested capital (i. e., 10 per cent of $90,410.96) or $9,041.11, a total of $11,291.11. The war-profits credit is computed in this case under Section 311 (b), because the

amount computed under 311 (a) (2) is less than 10 per cent of the invested capital. The amount computed under 311 (a) (2) would be 9/12 of the sum of the average prewar net income or $3,500, plus 10 per cent of the amount by which the full invested capital of $120,000 actually used during the taxable period exceeds the average prewar invested capital of $50,000 (i. e., 10 per cent of $70,000) or $7,000, a total of $10,500, 9/12 of which is $7,875. This amount is less than 10 per cent of the invested capital for the taxable year as computed under Section 311 (b). It will be noted that as provided in Section 326 (d) the invested capital used in Section 311 (a) (2) is the full amount of $120,000, but that the invested capital used for all other purposes of 275/365 of this amount or $90,410.96.

FIRST BRACKET. The amount or portion of the net income ($50,000) in excess of the excess-profits credit ($9,482.88) and not in excess of 20 per cent of the invested capital (i. e., 20 per cent of $90,410.96) or $18,082.19 is $8,599.31. The tax computed under this bracket is 30 per cent of this amount (i. e., 30 per cent of $8,599.31) or $2,579.79.

SECOND BRACKET. The amount or portion of the net income ($50,000) in excess of 20 per cent of the invested capital (i. e., 20 per cent of $90,410.96) or $18,082.19 is $31,917.81. The tax computed under this bracket is 65 per cent of this amount (i. e., 65 per cent of $31,917.81) or $20,746.58.

THIRD BRACKET. Eighty per cent of the amount or portion of the net income in excess of the war-profits credit (i. e., 80 per cent of the amount by which $50,000 exceeds $11,291.11, or $38,708.89) is $30,967.11. The amount of the tax computed under the first and second brackets ($2,579.79 plus $20,746.58) is $23,326.37. The tax computed under this bracket is the amount by which $30,967.11 exceeds $23,326.37 or $7,640.74.

TOTAL TAX. The total tax would be the sum of the taxes computed under the three brackets (i. e., $2,579.79 plus $20,746.58 plus $7,640.74) or $30,967.11, were it not that Section 302 provides that the maximum tax shall not in this case exceed $29,100. The total tax for the nine months ending December 31, 1918, is therefore $29,100.

No. 10. Illustration of Computation of Limitation. In illustration No. 9, the net income is $50,000 and the war excess-profits tax as computed under Section 301 (a) is $30,967.11. Section 302 of the statute provides, however, that the tax under Section 301 (a)

shall not be more than 30 per cent of the net income in excess of $3,000 and not in excess of $20,000 (i. e., 30 per cent of $17,000 or $5,100, plus 80 per cent of $30,000) or $24,000, a total of $29,100. In this case the tax under Section 301, amounting to $30,967.11, will be reduced by the provisions of Section 302 to $29,100.

CHAPTER 46

THE CAPITAL STOCK TAX

This tax is popularly known as the Capital Stock Tax, although the statute describes it as "a special excise tax with respect to carrying on or doing business." The present law [1] describes the tax in the same manner as did the 1916 Law [2] and imposes a tax "on and after July 1, 1918, in lieu of the tax imposed by the 1916 Law." The tax is imposed upon every domestic [3] corporation [4] and upon every foreign [5] corporation doing business in the United States. The Revenue Act of 1918 in imposing this tax, does not, like the 1916 Law, limit the corporations taxed to those organized "for profit" and apparently applies to every corporation having capital stock whether organized for profit or not, except those exempt from income tax under Section 231 of the Revenue Act of 1918.[6] The tax is imposed "with respect to carrying on or doing business" and is payable in advance by every taxable cor-

1 Rev. Act of 1918, § 1000.

2 Act of September 8, 1916, § 407.

3 The term "domestic" when applied to a corporation, means "created or organized in the United States." (Revenue Act of 1918, § 1.)

4 The term "corporation" includes "associations, joint-stock companies and insurance companies." (Rev. Act of 1918, § 1.)

5 The term "foreign," when applied to a corporation, means "created or organized outside the United States." (Rev. Act of 1918, § 1.)

6 Rev. Act of 1918, § 1000. The 1916 Law provided expressly that corporations exempt under the provisions of Section 11 of the 1916 income tax law were also exempt for purpose of the capital stock tax.

poration engaged in business during any part of the preceding year.

Definitions. The word "corporation" is used in this chapter, unless otherwise stated, in the sense defined in the Revenue Act of 1918, and includes a corporation, association, joint-stock company, or insurance company. The phrase "taxable year" as used in this chapter means the fiscal year of the Government beginning on the first day of July of each calendar year and ending on the last day of June the year following. The phrases "preceding year" and "preceding taxable year" mean the twelve-month period ending immediately prior to the "taxable year" as above defined.

Domestic Corporations. The tax applies to a domestic corporation if (a) it is carrying on or doing business; (b) has capital stock; (c) was engaged in business for some part of the preceding year ending June 30th, and (d) is not one of the corporations enumerated as exempt for purpose of income tax. The 1916 Law provided that the corporation should be organized for profit and have a capital stock represented by shares. In this respect the 1918 Law is broader in its scope. It should be noted that the law applies not only to corporations but also to all associations "organized in the United States" and in this respect seems to be broader in its scope than the 1909 Law, which was construed to apply only to corporations, joint-stock companies or associations "organized under the laws of the United States or of any State or Territory of the United States or under the Acts of Congress applicable to Alaska or the District of Columba."[7] Appar-

[7] It was the intention of Congress to embrace within the 1909 Law only such corporations and joint-stock associations as were organized under some statute or derived from that source some quality or benefit not existing at the common law. (Eliot v. Freeman, 220 U. S. 178.) This was a case involving a so-called "Massachusetts Real Estate Trust" which was held not to be taxable under the 1909 Law but which would seem to be taxable under the capital stock tax law.

ently it was the intent of Congress to make the present as well as the former capital stock tax law apply to associations which were held not to be taxable under the 1909 Law, because not organized under some statute.

Foreign Corporations. A foreign corporation is taxable if (a) it is "carrying on or doing business in the United States" during the taxable year; (b) was engaged in business in the United States during some part of the preceding year ending June 30th; (c) is not one of the corporations enumerated in Section 231 of the law as exempt from income tax, and (d) has capital employed in the transaction of its business in the United States.[8] It is to be noted that a foreign corporation is not subject to this tax merely because it receives income from sources within this country. To be taxable, a foreign corporation must be carrying on or doing business in the United States and must have capital employed in the transaction of such business. The chapter on foreign corporations, in the foregoing part of this book, contains decisions and rulings which define what is "doing business" by foreign corporations, and such decisions and rulings have application to this tax. It should be borne in mind, however, that some of the rulings with respect to the taxability of foreign corporations under the income tax law have no application to this law, since this tax is imposed only when the foreign corporation is carrying on or doing business in this country and has capital employed in the transaction of such business.[9]

Basis and Rate of Tax. The basis of the capital stock tax differs accordingly as the taxable corporation is domestic or foreign or is an insurance company.

Domestic Corporations. The basis of the tax in the case of all domestic corporations is "the fair average value of its capital stock for the preceding year ending June 30th." No deduction is allowed by reason of the fact that a part

[8] Rev. Act of 1918, § 1000.

[9] Laurentide Co., Ltd., v. Durey, 231 Fed. 223, and Bryant & May, Ltd. v. Scott, 226 Fed. 875 are cases in point. See Page 251.

of the capital stock may be represented by assets in foreign countries[10] or that a part of the capital may be invested in business and a part may not.[11] The rate of tax is $1 for each $1,000 of the fair average value of the capital stock of the excess over $5,000. Fractional parts of $1,000 are disregarded.

FAIR AVERAGE VALUE OF CAPITAL STOCK. The law provides that in estimating the value of capital stock surplus and undivided profits shall be included. Prior to July 1, 1918, it was the practice of the Treasury Department to determine the fair average value of capital stock by means of either (a) the average price at which stock had sold during the preceding year or (b) by estimating the value of the capital stock taking into consideration the surplus and undivided profits for the preceding fiscal year as well as the nature of the business, its earning capacity and average dividends paid, or profits earned during the preceding five years. Only in exceptional cases, where the corporation had no net income or only occasional income, was the value of the capital stock predicated upon the value of the assets of the corporation. In August 1918 new regulations were issued by which corporations were required to make three exhibits: Exhibit A being a condensed balance sheet; Exhibit B, quotations or outside sales prices, and Exhibit C, the annual income for a period of five years. The taxpayer was required to report as the fair value of its capital stock the amount reflected by the exhibit showing the greatest value. However, corporations materially affected by extraordinary conditions were permitted to report the amount reflected by the exhibit which in their opinion more nearly showed the required value, in which case it was necessary to attach to the return a comprehensive statement explaining why the tax should be so assessed.

EXHIBIT A: CONDENSED BALANCE SHEET. This exhibit

10 Reg. 38 Rev., Art. 7. T. D. 2417.
11 Reg. 38 Rev., Art. 7.

furnished a condensed balance sheet as of the closing date of a fiscal year ending on June 30, 1918, or on some date between July 1, 1917, and June 30, 1918, of the preceding year. In one column the value shown on the books of account were required to be stated and in a parallel column adjustment might be made for any overstated or understated values shown on the books of account. In a third column the taxpayer was required to show the difference between the book values and the "fair value." Any material difference was to be explained in such manner as to enable the Commissioner to determine if the "fair value" was proper and acceptable. In making adjustments from book values to fair value it was not necessary for the taxpayer to make corresponding adjustments on its books of account. In the event that the taxpayer held in its treasury any of its own stock or bonds it was required that advice be given as to whether such stock or bonds were pledged or unpledged.

EXHIBIT B: QUOTATIONS OR OUTSIDE SALES PRICES. In this exhibit the taxpayer was required to show prices quoted on a recognized stock exchange or on the New York Curb, or the prices at which outside sales were made if the stock was not listed, for the period of twelve months ending with the close of the taxpayer's last fiscal year. A statement of the number of shares involved and the conditions under which sales were made at other than exchange quotations was required to accompany the return. Sales to employees or directors for qualifying shares, or sales which were restricted as to resale, or sales at prices otherwise specially influenced, were not considered representative of the fair value of the entire capital stock and were not to be reported.

EXHIBIT C: ANNUAL INCOME. In this exhibit the taxpayer was required to furnish data for the five fiscal years ended with the close of the taxpayer's last fiscal year or for the period during which the corporation had been engaged in business, if for a shorter period. The net income reported for the purpose of the income tax was re-

quired to be stated in this exhibit. Such net income, however, could be adjusted by deductions or additions in order to reach the actual operating income. Among the principal items which might require adjustment were stated: income taxes not deductible in computing income subject to tax; depreciation and depletion of temporary or permanent property; amortization of temporary plant and equipment; interest charges not deductible in computing income subject to tax; abnormal income due to extraordinary appreciation in value of inventory; losses not fully deductible; income exempt for purpose of the income tax: expenditures made for additions or betterments, or reserves for such purposes, made against income whether direct or through expenses. The adjusted income was to be averaged for the years reported and such average income capitalized at such percentage as the officers of the company making the return from their special familiarity with the business knew representative enterprises in their line in their locality must earn in order to maintain their stock at par. In other words, if enterprises engaged in a similar business found it necessary on the average to earn 8% on their issued capital stock to keep the value of their stock at par, the net income of the corporation making the report was to be capitalized by dividing it by .08.

The purpose of the regulation was to permit the taxpayer to take into consideration any and all abnormal conditions affecting the book value of the assets or the earning power of the corporation as shown by its average net income. Such opportunity having been given the book value of the assets and the capitalized net income were compared with the actual sales prices of the stock and the largest of the three was taken as representing the fair average value of the capital stock unless the Commissioner could be convinced that one of the other two values more clearly reflected the fair average value of the capital stock.

Foreign Corporations. In the case of a foreign corporation the tax is imposed upon the "average amount of

capital employed in the transaction of its business in the United States during the preceding year ending June 30th." Bank accounts carried by a foreign corporation in this country are to be considered in computing the amount of capital employed therein if the money is carried on the books of the corporation as capital invested in its business in this country, but not if the money is kept here merely for convenience or investment.[12] Any surplus or undivided profits of a foreign corporation invested in United States bonds or other securities having no connection whatever with the actual business of the corporation transacted in this country is not "capital employed in the transaction of its business in the United States."[13] One of the rules prescribed by the Treasury Department for determining capital employed in the transaction of business of a foreign corporation in the United States for the year ending June 30, 1917, was as follows: (1) Take the entire invested capital of the corporation, as shown by its last return within the year ending June 30 for the purpose of the war excess-profits tax imposed by the Act of October 3, 1917, or if no such excess-profits tax return has been made by the corporation, compute the invested capital for its fiscal year ending within the year ending June 30 in accordance with the War Excess Profits Tax Regulations. (2) Find the proportion, expressed in percentage, which the net income from sources within the United States bears to the entire net income for the fiscal year ending within the year ending June 30, such income being ascertained upon the same basis and in the same manner as for the income and excess-profits taxes. (3) Apply the percentage found in (2) to the average invested capital ascertained in (1), the result being the amount of capital invested in the United States.[14] The present rate of tax is $1 for each $1,000 of the average amount

[12] Letter from Treasury Department dated February 10, 1917, W. T. S. 1918, ¶ 3131.

[13] So held under 1916 Law. See T. D. 2467.

[14] Reg. 38 Rev., Art. 20.

of capital employed in the transaction of business in the United States. Fractional parts of one thousand dollars are disregarded.

Insurance Companies. In computing the tax in the case of insurance companies (domestic or foreign) such deposits and reserve funds as they are required by law or contract to maintain or hold for the protection of or payment to or apportionment among policyholders is not to be included in the fair average value of their capital stock. In the case of a domestic mutual insurance company the tax is to be the equivalent of $1 for each $1,000 of the excess over five thousand dollars of the sum of its surplus or contingent reserves maintained for the general use of the business and any reserves the net additions to which are included in net income under the provisions of the income tax law, as of the close of the preceding accounting period used by such company for purpose of making its income tax return.[15] In the case of a foreign mutual insurance company the tax is the equivalent of $1 for each $1,000 of the same proportion of the sum of such surplus and reserves which the reserve fund upon business transacted within the United States is of the total reserve upon all business transacted, as of the close of the preceding accounting period used by such company for the purpose of making its income tax return.[16] Fractional parts of one thousand dollars are disregarded.

Holding Companies. The Treasury Department held under the 1916 Law that a domestic holding company whose objects and activities were exclusively restricted to holding the stock and securities of other corporations was not "doing business" and was, therefore, not subject

[15] Rev. Act of 1918, § 1000 (c). Under the 1916 capital stock tax law it was held that mutual insurance companies and other associations not having capital stock represented by shares would be held exempt from the tax in the absence of a basis for the computation thereof under that law. T. D. 2364.

[16] Id.

to tax.[17] This ruling was based upon a case[18] holding that no holding company can exist without a corporate activity involved in the exercise of control of its subsidiaries through stock ownership, but such corporate activity is not the exercise of a franchise which is subject to an excise tax. If a holding company is "doing business" no deduction is allowed to it for the tax paid by its subsidiary.[19] Foreign holding companies are subject to the same rule.

Subsidiary Companies. A subsidiary company is taxed regardless of its relations to the principal or parent company.[20] The law does not provide against taxation of the value of the capital stock of parent and subsidiary corporations, although the value of both may be supported in part by the same assets.

Limited Partnerships. Limited partnerships are subject to this tax if they are subject to the income tax as corporations.[21]

Engaged in Business During Preceding Taxable Year. A domestic corporation is not subject to tax in any taxable year unless two conditions co-exist: (a) it must have been engaged in business during the preceding year, and (b) it must be carrying on or doing business in the taxable year. It is not necessary, however, that such corporation should have been engaged in business during the entire preceding year. If it was engaged in business at some time during the preceding year, the length of time has no bearing upon the amount of tax due. A corporation commencing business on the last day of the preceding year

17 Reg. No. 38 Rev., Art. 6. These revised regulations reversed the earlier holding of the Treasury Department, and were based upon the case cited in the next note. See T. D. 2429. T. D. 2503.

18 Butterick Co. v. U. S., 240 Fed. 539; U. S. v. Nipissing Mines Co., 206 Fed. 431. See the paragraph on Carrying on or Doing or Engaging in Business, post.

19 Reg. 38 Rev., Art. 24.

20 Revenue Act of 1918, § 1000 (a) (1). See T. D. 2493, as amended by T. D. 2509.

21 Reg. 38 Rev., Art. 2, Appendix A, General Instruction 3.

was held by the Treasury Department to be subject to the tax imposed by the former law to the same extent as though it had been engaged in business for the entire year, and the full rate of tax for the taxable year was imposed.[22] The same rule applies in respect to foreign corporations, except that the business in question must be engaged in or carried on or done in the United States.

Inactive Corporations. A domestic corporation is not taxable unless it carries on or does business in the taxable year. But if such corporation has paid the special excise tax at the beginning of the taxable year and ceases to do business before the close of that year, no refund is allowed for that portion of the year in which the corporation does no business.[23] The same rule applies in respect to foreign corporations except that the business in question must be engaged in or carried on or done in the United States.

Carrying on or Doing Business During Taxable Year. A domestic corporation not engaged in business at the beginning of the taxable year is not required to file a return or pay a tax, although it may have been engaged in business during a part of the preceding year. If such corporation resumes business at any time during the taxable year, it will be required, at that time, to make a return and pay the tax for the proportion of the year in which it intends to do business. In such cases the tax is computed proportionately from the first day of the month in which it carries on or does business to the end of the taxable year. Thus, if a corporation was engaged in business during some part of the preceding year, but was not engaged in business on the first day of the taxable year, but subsequently engages in business in the third month of the taxable year, the return is required to be filed and the tax be paid at that time, for ten-twelfths of the full taxable year. If an inactive corporation was not engaged in busi-

22 Reg. 38 Rev., Art. 11; T. D. 2417.
23 See R. S. § 3237.

ness during any part of the preceding year, it is not taxed in the year it resumes activity, but makes a return and pays the tax at the beginning of the next taxable year.[24] A corporation organized after the beginning of the taxable year is not subject to tax for the remaining portion of the year in which it was organized, but when one corporation succeeds another at the beginning of a taxable year, and the old corporation, pursuant to an agreement entered into between the respective organizations during the preceding year, ceases to "do business" at that time, the business being carried on thereafter by the new concern, the new corporation is liable to tax.[25]

Carrying on or Doing Business. The tax is imposed "with respect to the carrying on or doing business" by a corporation. It may be described generally as a tax upon the doing of business in the capacity of a corporation, joint-stock company, or insurance company. "Business" is a very comprehensive term and embraces everything about which a person can be employed. Every corporation that is doing business, and no corporation that is not carrying on or doing business, is subject to the tax. As corporations are organized to do business, every existing corporation will be presumed to be subject to the tax unless it submits proof satisfactory to the Commissioner that it is not doing business. The distinction is between the mere ownership of property and the actual doing of business in the capacity above designated. The fair test is whether a corporation has reduced its activities to the owning and holding of property and the distribution of its avails and doing only the acts necessary to continue that status, or is still active and is maintaining its organization for the purpose of continued efforts in the pursuit of profit and gain and such activities as are essential to those purposes.[26] The meaning of the term "en-

[24] Reg. 38 Rev., Arts. 1 and 11.

[25] Reg. 38 Rev., Art. 11.

[26] Reg. 38 Rev., Art. 4. Von Baumbach v. Sargent Land Co., 242 U. S. 503.

gaged in business'' in relation to domestic corporations was defined by a number of decisions under the 1909 Law, with particular reference to cases where corporations had ceased to do business. Thus, it was held that where a corporation, originally organized for the purpose of owning and renting an office building, leased its property for 130 years, its sole authority under its charter thereafter being to hold the title subject to the lease and to receive and distribute the rentals which might accrue under the terms of the lease, or the proceeds of any sale of the land if it should be sold, was not engaged in business within the meaning of that law.[27] In another case, it was held that a railroad corporation which had leased its property for a term of years, and parted with its control and management, maintaining, however, its corporate organization, collecting rentals from the lessee, and distributing the same among its stockholders, was not engaged in business.[28] Where, however, a corporation was organized to build and lease property, the fact that it had leased all of its property and did nothing except collect and distribute the rents, did not exempt it from the tax, since such collection and distribution of rents from the leased property was the business for which it was organized.[29] A company whose activities include something more than the mere holding of property and the distribution of the receipts thereof is ''doing and engaging in business.''[30]

27 Zonne v. Minneapolis Syndicate, 220 U. S. 187. In a later case it was held that, although a corporation might have power to do business under its charter, if it had leased all its property and was merely collecting rent it was not engaged in business. U. S. v. Emery, etc., Co., 237 U. S. 28.

28 McCoach v. Mine Hill & Schuylkill Haven R. R. Co., 228 U. S. 295.

29 Rio Grande Junction Ry. Co. v. U. S., 51 Ct. Cls. 274.

30 Von Baumbach v. Sargent Land Co., 242 U. S. 503. The activities referred to in this case included selling and leasing property, selling stumpage, making explorations, and employing another company to see that mining operations were properly carried on and that the lessees lived up to their engagements.

These and other decisions [31] will be followed by the Treasury Department where the decisions are by the United States Supreme Court or, if by the lower courts, have been acquiesced in by the Department. Corporations organized for the purpose of buying, owning, exploring, developing, leasing, improving, selling and dealing in lands, mining properties, tenements, and hereditaments, are considered to be engaged in business if they perform any of their powers. It is not necessary that such a corporation be an operating company in order to be taxable under this law. If a corporation is doing any one of the several things it is authorized to do, by its charter, it is carrying on or doing business and subject to this tax.[32] But if a corporation is solely a holding company it is not carrying on or doing business within the meaning of the law.[33] Corporations, all of whose property and business is operated by or in the hands of receivers appointed by a court or the Alien Property Custodian, are not engaged in business.[34]

FOREIGN CORPORATIONS. A foreign corporation is "carrying on or doing business" in the United States if it maintains agents or an office or warehouse here, or in the case of an insurance company writes insurance policies here or in any other way enters the United States for the purpose of its business.[35] The meaning of the term in

[31] Other cases arising under the 1909 Law are: Anderson v. Morris & Essex R. R. Co., 216 Fed. 83; Cambria Steel Co. v. McCoach, 225 Fed. 278; Jasper, etc., Ry. Co. v. Walker, 238 Fed. 533; Lewellyn v. Pittsburg, etc., R. R. Co., 222 Fed. 177; McCoach v. Continental Passenger Ry. Co., 223 Fed. 976; Miller v. Snake River Valley R. R. Co., 223 Fed. 946; New York Central v. Gill, 219 Fed. 184; New York Mail, etc., Co. v. Anderson, 234 Fed. 590; Philadelphia, etc., R. R. Co. v. Lederer, 242 Fed. 492; Philadelphia Traction Co. v. McCoach, 224 Fed. 800; Public Service Electric Co. v. Herold, 229 Fed. 902; Traction Companies v. Collector of Internal Rev.; 223 Fed. 984; Wilkes-Barre, etc., Traction Co. v. Davis, 214 Fed. 511.

[32] T. D. 2457.

[33] Butterick Co. v. U. S., 240 Fed. 539; Reg. 38 Rev., Art. 6.

[34] Reg. 38 Rev., Art. 6; T. D. 2424.

[35] Reg. 38 Rev., Art. 13.

relation to foreign corporations has been referred to in a previous paragraph.[36]

Exempt Corporations. The special excise tax is expressly made inapplicable to any corporation exempt for income tax purposes.[37] As foreign corporations falling within the classes enumerated as exempt in the income tax law (except in the case of building and loan associations and cooperative banks) are exempt for income tax purposes,[38] they are also exempt from this tax, if falling within such enumerated classes. A corporation paying this tax is not on that account exempt from any occupational tax.[39]

Tax Due. This tax is an excise tax on the privilege of doing business, similar to occupational taxes imposed on individuals. Being a privilege or occupational tax, it is payable annually, in advance,—in July, the beginning of the Government's fiscal year, by domestic corporations making no income tax return or making such return on the basis of a fiscal year corresponding to the Government's fiscal year and by foreign corporations in the first month of the taxable year by other taxable corporations. The tax is payable to the collector, at any time after such due date, but penalties for non-payment do not attach until ten days after notice and demand therefor have been served by the collector upon the taxpayer.[40]

Returns. Returns are required to be filed in July of each year with the collector of the district in which the principal place of business of the corporation is located. Forms will be sent to taxable corporations known to collectors, but failure to receive a blank form will not relieve

36 See p. 788.

37 Revenue Act of 1918, § 1000 (c).

38 Letter from Treasury Department dated December 6, 1916; I. T. S. 1918, ¶ 1182; Reg. 38 Rev., Art. 12.

39 Reg. 38 Rev., Art. 17.

40 See T. D. 2423, and Chapter 35 for rulings as to notice and demand.

a corporation from the penalties prescribed by law for failure to make the return within the time required.[41]

In What Cases Required. A return is required of every domestic corporation engaged in business, having a capital stock issued and outstanding, regardless of the par value, or the actual value, of its capital stock, unless such corporation was not engaged in business during the preceding taxable year.[42] Subsidiary corporations, all or a part of the stock of which is owned by another corporation, are required to file returns in the same way as other corporations.[43]

Extension of Time. Under the former law an extension of time for filing the capital stock return could be obtained in the case of sickness or absence, such extension not to exceed thirty days.[44] Under the present law extensions may be granted to the same extent as in the case of income tax returns.

Returns to Be Public Records. Returns filed pursuant to the special excise tax law, constitute public records, and are open to inspection in all respects the same as income tax returns.[45]

Foreign Corporations. A return is required of every foreign corporation irrespective of the amount of capital employed either in this country or elsewhere in the transaction of its business.[46] Returns are filed with the local collector under the rules which apply to the filing of returns of annual net income.[47]

Payment of the Tax. All assessments are made by the Commissioner. The collector, within ten days after receiving any list of taxes from the Commissioner gives notice

41 Reg. 38 Rev., Art. 21. T. D. 2364. Domestic corporations used Form No. 707 under the former law.

42 Reg. 38 Rev., Art. 18.

43 Reg. 38 Rev., Art. 24.

44 Revenue Act of 1918, § 1317.

45 Reveune Act of 1918, § 1000 (d).

46 See T. D. 2383.

47 See Reg. 38 Rev., Appendix B.

to each corporation liable to pay any tax stated therein, to be left at its place of business or to be sent by mail, stating the amount of such tax and demanding payment thereof. A collector has no authority to extend the time for payment of the tax. The collector may accept payment of the tax when the return is filed as an "advance collection," subject to any adjustment later found necessary, but no corporation is required to pay the tax until within ten days after notice and demand.[48]

Penalties. Any corporation carrying on business within the meaning of Section 1000 of the Revenue Act of 1918 without having paid the tax therein provided is subject to a penalty of not more than $1,000 besides being liable for the payment of such tax.[49]

PENALTY FOR FAILURE TO MAKE RETURN. If a corporation fails to make a return on or before the time required by law in any year, the collector or deputy collector may make a return from his own knowledge or from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge or from such information as he can obtain through testimony or otherwise, make a return or amend any such return made by a collector or deputy collector. Any return so made and subscribed by the Commissioner, or by a collector or deputy collector, and approved by the Commissioner is *prima facie* good and sufficient for all legal purposes. A penalty of 25% of the amount of the tax so found due will be added, unless a return is made and it is shown that the failure to file it was due to a reasonable cause, and not to wilful neglect. The amount so added to any tax (or the amount added, as stated in the next paragraph) will be collected at the same time and in the same manner and as part of the tax unless the tax has been paid before the discovery of the neglect, fal-

[48] Reg. 38 Rev., Art. 23.
[49] Revenue Act of 1918, § 1005.

sity, or fraud, in which case the amount so added will be collected in the same manner as the tax.[50]

FALSE OR FRAUDULENT RETURN. In case a false or fraudulent return is wilfully made, the Commissioner will add to the tax 50% of the amount thereof.[51]

PENALTY FOR DELAY IN PAYING TAX. Upon failure to pay the tax assessed within ten days after notice and demand, a penalty of 5 per cent. of the tax unpaid, and interest at the rate of one per cent. per month until paid, is added to the amount of such tax.[52]

FOREIGN CORPORATIONS. The above penalties apply to foreign corporations as well as domestic corporations.[53]

Additional Penalties. In addition to the penalties discussed above, certain further penalties relating to the Special Excise Tax are provided in the Revenue Act of 1918, Section 1308.

Administration of the Law. All administrative or special provisions of the internal revenue laws including the laws relating to the assessment of taxes, so far as applicable, are extended to and made a part of the Revenue Act of 1918 (including the Special Excise Tax) and every corporation liable to the tax considered in this chapter is required to keep such records and render, under oath, such statements and returns, and comply with such regulations as the Commissioner may prescribe.[54]

50 R. S. § 3176, as amended by the Revenue Act of 1918. See Reg. 38 Rev., Arts. 21 and 22; General Instructions Appendix A 4, 9.

51 R. S. § 3176, as amended by the Revenue Act of 1918. See Reg. 38 Rev., Art. 22; Appendix A, General Instructions 9.

52 Revenue Act of 1918, § 1305; R. S. § 3184.

53 See Reg. 38 Rev. Appendix B.

54 Rev. Act of 1918, § 1305.

CHAPTER 47

THE STAMP TAX

The present stamp tax is imposed under Title XI of the Revenue Act of 1918, which became a law on February 25, 1919. This title is to some extent a re-enactment of the War Stamp Tax Act of 1917 (Title VIII of the Act of October 3, 1917, referred to in this chapter as the "former" or 1917 law), but the two acts differ in certain respects. The Revenue Act of 1918, like the former law, does not contain Schedule B of the Act of October 22, 1914 (referred to in this chapter as the 1914 Law), which provided for a tax on perfumery, cosmetics and similar articles, and chewing gum or substitutes therefor. The 1914 Law was preceded by the Act of June 13, 1898 (referred to in this chapter as the 1898 Law).[1] The taxes imposed by the Revenue Act of 1918 are, in the case of any article upon which a corresponding stamp tax was hitherto imposed by law, in lieu of such tax.[2] The date of the incidence of the tax, that is, the first day on which the tax applied, is February 25, 1919.[3]

General Scope of Present Law. The present law taxes the following subjects: Bonds (of indebtedness, indemnity and surety), the original issue of certificates of stock or of profits or interest in property or accumulation of corporations, the sale or transfer of shares or certificates of stock

1 Other stamp tax acts will likewise be referred to in this chapter for the sake of brevity by the year of their respective enactments.

2 Revenue Act of 1918, § 1100.

3 The former law went into effect on December 1, 1917, except as to the tax on playing cards, which became effective on October 4, 1917.

or of profits or of interest in property or accumulation in corporations, sales of produce on exchange, drafts or checks (payable otherwise than on sight or on demand), promissory notes, conveyances, entries of goods at custom house, entry for withdrawal of goods from custom bonded warehouse, passage tickets on vessels to foreign countries (except Canada or Mexico), proxies, powers of attorney, playing cards, parcel post packages and certain insurance policies. The several subjects appear below in alphabetical order, together with the rates applicable to each and rulings with respect to each. This list includes a number of instruments not taxable under the present law to which reference is made for the convenience of the reader who may be searching for positive assurance that a particular instrument need not be stamped.

General Exemptions. The following are not subject to stamp tax: (a) bonds, notes, or other instruments issued by the United States, or by any foreign government, or by any State, Territory, or the District of Columbia, or local subdivision thereof, or municipal or other corporation exercising the taxing power; (b) bonds of indemnity required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States; (c) stocks and bonds issued by co-operative building and loan associations which are organized and operated exclusively for the benefit of their members and make loans only to their shareholders, or by mutual ditch or irrigating companies.[4] Special exemptions applying to various instruments specified in the law are referred to in the paragraphs dealing with such instruments.

Stamps. Stamps are kept on sale by the various postmasters in the United States,[5] and are also on sale at United States depositaries.[6]

WHERE STAMPS ARE AFFIXED. As a rule, stamps are affixed to the taxable document or instrument, but in some

[4] Revenue Act of 1918, § 1101.
[5] Revenue Act of 1918, § 1106.
[6] Revenue Act of 1918, § 1107.

instances a different rule prevails, as will appear in the following paragraphs.

WHO AFFIXES STAMPS. It is contemplated that stamps shall be affixed by the person issuing the document or instrument. Thus, the maker of a promissory note is primarily obliged to affix the proper stamp thereto, and likewise, the obligor should affix the proper stamp to a bond. However, it is secondarily the duty of a person accepting or receiving any such document or instrument to affix a stamp thereto and he is subject to penalty if he does not do so. It has been held that it makes no difference who affixes the stamp, as long as a stamp of the proper denomination is affixed to the instrument.

CANCELLATION OF STAMPS. Stamps are cancelled by the person using or affixing the stamp, by writing or stamping thereon in ink his initials and the day, month, and year on which the stamp is used or affixed. In addition, stamps of the value of 10 cents or more are required to be cancelled by either (a) three parallel incisions made by some sharp instrument lengthwise through the stamp after the stamp has been attached to the instrument, or (b) by cutting or cancelling the stamp with a machine or punch which so defaces the stamp as to render it unfit for reuse. The cancellation by either method should not so deface the stamp as to prevent its denomination and genuineness from being readily determined.[7] The perforating machine may also imprint the initials and date or outline the same in small perforations, thus effecting complete cancellation, or the initials and date may be written on the stamp and several perforations, sufficient to prevent washing and resale of the stamp may be made with an ordinary hand punch before fixing the stamp to the document.[8] Where the initials of a person, firm or corporation have been perforated on the stamps before being used it is sufficient when the stamps are actually attached to the document to stamp the same

[7] Reg. No. 40, Part 1, Art. 7.
[8] T. D. 2098.

with the full initials and date. Where the initials of a firm or company have been stamped or written on a stamp it is not required that the individual employee affixing the stamp shall also place his own initials thereon.[9] It has been held that stamps on promissory notes were properly cancelled when they were so used and defaced that they could never be legally used again.[10] It has also been held that the failure to write the initials of the payee's name on a promissory note, when he was affixing a stamp and cancelling the same in the presence of the court before offering the note in evidence, did not affect its sufficiency.[11] In a case decided in 1865,[12] it was held that when a bond was executed by two obligors, it was sufficient if the stamp was attached and cancelled by one of them.

Bonds of Indebtedness. Bonds, debentures or certificates of indebtedness, however termed, issued on and after February 25, 1919, by any person, corporation, partnership or association are taxable at the rate of 5 cents on each $100 of face value or fraction thereof.[13]

WHERE STAMPS ARE AFFIXED. The stamps denoting the tax should ordinarily be affixed to the bonds. If temporary bonds are first issued, to be later exchanged for permanent or definitive bonds, the stamps may be affixed to the indenture, in which case a statement that the stamps were

[9] Letter from Treasury Department dated December 9, 1914.

[10] Taylor v. Duncan, 33 Tex. (1870) 440.

[11] Foster v. Holley's Adm'rs, 49 Ala. (1873) 593. The court in this case does not decide the question whether an improperly stamped note could be excluded from evidence in the state courts. See Page 867.

[12] Teagarden v. Garver, 24 Ind. 399. In this case, the court says: "The object of the Act of Congress is to raise revenue, and the stamps are required to be cancelled to prevent their use a second time. This was fully accomplished by one of the obligors cancelling it, as required by the Act of Congress." The court referred to the doubtful character of the power of the federal government to make a rule excluding improperly stamped instruments from evidence in the state courts, and the court's opinion indicates that this doubt was a factor in its decision. See Page 867.

[13] Revenue Act of 1918, § 1107, Schedule A-1.

affixed to the indenture must be printed or engraved on each bond.[14]

Definitions. Under the 1914 Law the tax was imposed only on bonds issued by corporations or associations. It is to be noted that the present act imposes the tax on bonds issued by persons and partnerships as well.[15] There is no clear distinction between bonds of indebtedness and promissory notes, and it is sometimes difficult to determine whether an instrument should be taxed under the higher rate applying to bonds of indebtedness or the lower rate applying to promissory notes. If the instrument is called a note but contains features not usual in or recognized as appertaining to the promissory note generally known to commerce, it is held in department practice to be taxable as a bond. Thus, under the 1914 Law it was held that an instrument designated as a "gold note" issued in the amount of $1,000 with interest coupons attached, and containing a promise by a corporation to pay a certain sum of money to the holder thereof under certain terms and conditions prescribed by the indenture of trust, was more in the nature of a bond or certificate of indebtedness than a promissory note and was, therefore, held taxable as a bond.[16] Instruments containing the essential features of a promissory note, but issued by corporations in numbers under a trust indenture, either in registered form or with coupons attached, embodying provisions for acceleration of maturity in the event of any default by the obligor, for optional registration in the case of bearer bonds, for authentication by the trustee, and sometimes for redemption before maturity, or similar provisions, are held to be bonds within the meaning of the statute, whether called bonds, debentures or notes.[17] Cer-

14 T. D. 2164; T. D. 2220.

15 Revenue Act of 1918, § 1107, Schedule A-1. See the definition of "person" contained in Revenue Act of 1918, § 1.

16 T. D. 2257. See definition under Promissory Notes, p. 842.

17 T. D. 2713.

tificates of deposit issued by banks and trust companies are not held to be taxable under this head.[18]

BONDS GIVEN IN A PENAL SUM. An instrument under seal conditioned in a penal amount for the payment of a sum of money, such as often accompanies mortgages, is a bond for stamp tax purposes.[19] When a bond conditioned for the repayment or payment of money is given in a penal sum greater than the debt secured, the tax is based upon the amount secured and not upon the amount of the bond.[20]

ISSUE OF BONDS. It seems generally that the delivery of the bond establishes the date of issue. Thus, it was held under the 1914 Law that bonds certified and delivered by a trustee after the incidence of the tax were taxable although subscribed and paid for prior thereto. Under the 1898 Law it seems to have been held that a bond was issued when delivery was made and the corporation received a benefit or a consideration therefor.[21] The date of renewal would be the date of issue for the purpose of the tax on a renewal of bonds.[22] Bonds issued by a domestic corporation in this country for sale to purchasers in a foreign country have been held to be issued here for the purpose of the tax, but bonds issued and sold by a domestic corporation in a foreign country have not been required to be stamped on the ground that the Government had no means of enforcing the statute in such case.[23]

RENEWAL OF BONDS. Every renewal of a bond, debenture or certificate of indebtedness is taxed as a new issue.[24] A renewal after the incidence of the tax of an instrument,

[18] T. D. 2054; letter from Treasury Department dated November 16, 1917; W. T. S. 1918, ¶ 3568. Such certificates were not taxed under the 1914 Law.

[19] T. D. 2713.

[20] Revenue Act of 1918, § 1107, Schedule A-1.

[21] Volume 1, Treasury Decisions No. 20156.

[22] Every renewal is taxed as a new issue. Revenue Act of 1918, § 1107, Schedule A-1.

[23] Letter from Treasury Department dated May 15, 1915.

[24] Revenue Act of 1918, § 1107, Schedule A-1.

issued prior thereto, will require the necessary revenue stamps.[25]

TRANSFER OF BONDS. No tax is imposed upon the transfer of bonds, debentures or certificates of indebtedness from one holder to another.

Bonds of Indemnity and Surety. Bonds of indemnity and surety are taxed at the rate of 50 cents. Where a premium is charged for the issuance, execution, renewal or continuance of such bonds, the tax is one cent on each dollar or fractional part thereof of the premium charged. Bonds coming within this class are (a) bonds for indemnifying any person, corporation, or partnership, who shall have become bound or engaged as surety, (b) all bonds for the due execution or performance of any contract, obligation, or requirement, or the duties of any office or position, and to account for money received by virtue thereof, (c) mortgage guarantee policies and policies guaranteeing title to real estate and (d) all other bonds of any description not otherwise provided for in Schedule A of Title XI. Policies of re-insurance are exempt from the tax imposed by this provision.[26]

BONDS DELIVERED PRIOR TO INCIDENCE OF TAX. Under the 1914 Law it was held that a bond executed and delivered prior to the date on which the tax was first imposed, whether or not taking effect immediately or subsequent to the enforcement of the taxing act, was not subject to the tax.[27] Premiums on indemnity or surety bonds executed prior to December 1, 1917, are not the subject of the stamp tax when premiums due and payable subsequent to December 1, 1917, are not essential to the continuance in force of such bonds. Where bonds issued prior to December 1, 1917, are continued in force after December 1, 1917, by the

[25] Letter from Treasury Department dated December 11, 1917; W. T. S. 1918, ¶ 3679.

[26] Revenue Act of 1918, § 1107, Schedule A-2.

[27] T. D. 2072.

execution of continuation certificates, the tax applies to the premium charged for the issuance of such certificates.[28]

Bonds Issued in Foreign Countries. It was held under the 1914 Law that bonds issued by guarantee companies in foreign countries guaranteeing the fidelity of individuals or corporations in the United States, executed and delivered in the foreign country, were not taxable but if they were not valid until countersigned or delivered by the agent in the United States, they should be taxed.[29] No ruling was issued upon this point under the 1917 Law.

Bonds Required in Legal Proceedings. Bonds of this class are not subject to tax although they may be bonds of indemnity. They include: (1) Bonds filed by order of court to obtain a decree or order for the sale of real estate; (2) bonds given by court officers under direction or authority of the court, to give proper effect to court proceedings, which bonds are practically a part of the record of a suit or proceeding in court; (3) bonds given in cases of appeal; (4) bonds given by executors, administrators, guardians and receivers appointed by the court;[30] and (5) indemnity or surety bonds given by trustees in bankruptcy for the purpose of qualifying as such.[31]

Fidelity and Surety Bonds. Fidelity and surety bonds are subject to the stamp tax.[32]

Mortgage Guarantee Policies and Policies Guaranteeing Titles to Real Estate. These policies are made expressly taxable by the 1918 Law. Under the 1917 Law, which was silent, it was held that, in common with policies of guarantee and fidelity insurance, mortgage guarantee policies and policies guaranteeing titles to real estate were

28 T. D. 2782.

29 T. D. 2051.

30 T. D. 2091. (Act of October 22, 1914.)

31 T. D. 2647.

32 Fidelity and surety bonds subject to tax levied with respect to insurance policies were exempt from the stamp tax under the Senate draft of the Revenue Act of 1918, but this exemption was stricken out by the Conference Committee.

subject to the stamp tax on bonds and not to the tax on insurance.[33]

BONDS GIVEN TO STATES AND POLITICAL SUBDIVISIONS THEREOF. It is held on the broad ground that the sovereign states and subdivisions thereof are constitutionally free from taxation by the Federal Government, that bonds given by officials of a state, township, county or village for the faithful performance of duties, are not taxable.[34] Bonds given to a state, township, county or village for the performance of contracts, such as the construction of state or municipal buildings, or the discharge of other duties strictly for or in behalf of the state, when necessary to protect the state's interest, are held not subject to taxation.[35] A bond given as a condition to the granting of a license by a state or political subdivision is not taxable if the license is issued in the exercise of the governmental powers of the state or political subdivision.[36] Under the 1898 Law a dramshop keeper's bond, given pursuant to the laws of Missouri, as a condition precedent to the grant of a license, was not subject to tax since such bond was required under the police power of the state—a power belonging exclusively within the state's jurisdiction—and was a means or instrumentality employed by the state in the exercise of one of its most important functions.[37] It was also held under the 1898 Law that neither the separate states nor the United States have power to impose a tax which will interfere with the sovereignty of the others within their own sphere, either by taxing their functions or the means by which they are exercised; that a power in the federal government to tax the right to qualify for the performance of duties of a state office is inconsistent with the existence of any supreme governmental authority in the state; and that therefore a bond required by a state from a notary public (who was

[33] T. D. 2704, modifying T. D. 2588.
[34] T. D. 2624. See T. D. 2111.
[35] T. D. 2624; T. D. 2072.
[36] Ambrosini v. U. S., 187 U. S. 1.
[37] U. S. v. Owens, 100 Fed. 70.

held to be an officer of the state) as a prerequisite to the exercise of his official duties is, in necessary legal effect, a tax on the officer's right to qualify and upon the exercise by the state of its governmental functions.[38]

BONDS GIVEN TO THE FEDERAL GOVERNMENT. Generally speaking bonds given to the federal government are taxable.[39] But the statute expressly provides that no bond of indemnity required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States shall be taxed.[40] Bonds of a private corporation delivered by it to the United States Housing Corporation as collateral security for a loan to aid the borrower in performing its contract with the United States Housing Corporation are subject to stamp tax.[41]

BONDS GIVEN BY UNITED STATES, FOREIGN GOVERNMENTS AND POLITICAL SUBDIVISIONS. All bonds given by the United States, or by any Foreign Government, or by any state, territory, or the District of Columbia, or local subdivision thereof, or municipal or other corporation exercising the taxing power are exempt from taxation.[42]

Building and Loan Associations. Stocks and bonds issued by co-operative building and loan associations which are organized and operated exclusively for the benefit of their members and make loans only to their shareholders, are not subject to the tax.[43] This provision of the law seems to exempt stock of such associations from the tax on original issue and also from the tax on sales or transfers. Any instruments other than certificates of stock and bonds are not exempt.[44]

38 Bettman v. Warwick, 108 Fed. 46. It was also held in this case that the fact that the tax was required to be paid before the officer qualified was unimportant.

39 T. D. 2624; T. D. 2111.

40 Revenue Act of 1918, § 1101.

41 T. D. 2782.

42 Revenue Act of 1918, § 1101; See T. D. 2072.

43 Revenue Act of 1918, § 1101.

44 Under the 1914 Law it was held that notes given to or by such associations were taxable (T. D. 2112).

Capital Stock, Issue. Although the heading of this paragraph is that used in the statute, the language of the law is that the tax shall be imposed "on each original issue, whether on organization or reorganization, of *certificates of stock,* or of profits, or of interest in property or accumulations, by any corporation." The rate is 5 cents on each $100 of face value or fraction thereof except where the certificate is issued without face value in which case the tax is 5 cents per share unless the actual value is in excess of $100 per share, in which case the tax is 5 cents on each $100 of actual value or fraction thereof. The stamps representing this tax are required by the law to be attached to the stock books and not to the certificates issued.[45] Where the blank stock certificates are not kept in a stock certificate book the stamps should be affixed to the books of record in which the issue of stock is recorded.[46]

CONTRACT TO ISSUE STOCK. No stamps are required to be affixed to a contract or agreement by a corporation to issue stock.[47] It seems that the tax is on the certificate and not on the issue of the shares.

ORIGINAL ISSUE. The tax on the issue of capital stock attaches to the issue of certificates of stock representing stock never before issued, no matter when authorized. If a corporation (1) issues preferred stock in place of common stock, or (2) one kind of preferred stock in place of another kind of preferred stock, or (3) stock without par value in place of stock with par value, the tax applies, even though the total outstanding stock is not thereby increased, but the tax does not apply to the mere issue of new certificates in place of old certificates of stock previously outstanding since that is not an original issue.[48] Stock certificates issued in lieu of original certificates in a case where a corporation had changed its name are not

45 Revenue Act of 1918, § 1107, Schedule A-3.

46 Letter from Treasury Department dated November 20, 1917, W. T. S. 1918, ¶ 3571.

47 T. D. 2599.

48 T. D. 2752.

taxable as an original issue. Temporary or interim stock certificates, issued before the permanent certificates, are taxable as original issue, but the subsequent exchange of such temporary certificates for the regular stock certificates to the same owner is not subject to any tax.[49] It was held under the 1914 Law that where bonds had been issued with the privilege of exchanging the same for certificates of stock, and the option was exercised after the incidence of the tax, the stock certificates then issued were taxable as an original issue, unless prior to the incidence of the tax the stock certificates in question had been issued and were held in trust for the purchaser of the bonds, in which case the rate of tax on transfers of stock was applicable.[50] An original issue made on reorganization is taxable. Thus, the tax on the issue of capital stock attaches to the issue of preferred and common stock, whether or not exchanged for old stock, upon a reorganization of a corporation under Section 24 of the New York Stock Corporation Law for the purpose of issuing stock without par value.[51] And it also applies to the issue of stock of either corporation in addition to its already existing stock upon a merger of trust companies under Sections 487-496 of the New York Banking Law.[52] The new issue of stock by a consolidated corporation in exchange for the stock of the consolidating corporations is a taxable original issue.[53]

CERTIFICATES OF STOCK. The present law applies to the issue of (1) certificates of stock, (2) certificates of profit, and (3) certificates of interest in property or accumulations, issued by any corporation. The 1917 Law applied only to certificates of stock. Under the 1914 Law, which

49 T. D. 2584. See T. D. 2752.

50 T. D. 2155.

51 T. D. 2752. See Page 820 for the rule respecting the tax on transfers of stock in this case.

52 T. D. 2752. See Page 820 for the rule respecting the tax on transfers of stock in this case.

53 T. D. 2752. See Page 820 for the rule respecting the transfers of stock in this case.

taxed certificates of profit "or any certificate or memorandum showing an interest in the property or accumulations of any association, company or corporation, * * * " it was held that certificates issued by trustees to persons who had deposited certain securities, such certificates issued by the trustees showing such persons to be entitled to a part of the dividends, etc., accruing on account of the securities deposited, were taxable as certificates of profits,[54] but under the present law it seems that certificates evidencing an interest in profits or accumulations are not taxable unless issued by a "corporation," as that term is used in the law.

ISSUED BY ANY CORPORATION. The term "corporation," as defined in Section 1 of the law, includes associations, joint-stock companies, and insurance companies. It has been held that the tax applies to the issue of certificates of shares in so-called Massachusetts trusts and other unincorporated associations.[55]

VOTING TRUST CERTIFICATES. Under the 1917 Law it was held that the tax did not apply to the issue of voting trust certificates representing stock certificates already issued.[56] Under the present law it has not yet been ruled whether or not such certificates are taxable as certificates "of profits, or of interest in property or accumulations" and it does not seem that they are so taxable unless issued by a corporation, since the tax is on certificates issued by any "corporation" as defined above.

STOCK OF DOMESTIC CORPORATIONS. The tax attaches to the issue of certificates of stock by a domestic corporation, no matter where the certificates are actually delivered.[57] This ruling was made in the case of stock issued

54 Letter from Treasury Department dated July 26, 1916, W. T. S., 1916, Page 353.

55 T. D. 2752.

56 T. D. 2752.

57 Letter from Treasury Department dated July 24, 1918; W. T. S. 1918, ¶ 3743. See page 805 as to bonds.

in Cuba by a Delaware corporation, all of whose operations were carried on in Cuba.

STOCK OF FOREIGN CORPORATIONS. Certificates of stock of foreign corporations sold or delivered within the United States are subject to the same tax as certificates of stock of domestic corporations. Stock of a corporation organized in a foreign country, issued in the United States, is subject to the tax on original issue.[58]

MEASURE OF TAX. The tax is measured, not by the amount paid in on, or for the stock, but by the face or par value of the stock, in the case of shares having a face or par value. The tax is imposed on the face or par value of the certificate and not upon the par value of each share. Thus, a certificate representing 10 shares of a par value of $10 each would be taxable as having a face or par value of $100. In the case of shares having no face or par value the tax is measured by the number of shares represented by the certificate unless the actual value of the stock is in excess of $100 per share in which case the tax is based upon the actual value of the stock represented by the certificate regardless of the number of shares.[59]

SHARES WITHOUT PAR VALUE. The actual value of shares without par or face value is a question of fact. For the purpose of this tax it may be determined by the statement of the company and the consideration involved in the issue of such stock,[60] or may be determined by the market price or otherwise.[61]

Capital Stock, Sales and Transfers. The law provides for a tax on (a) all sales, (b) agreements to sell[62] or mem-

[58] T. D. 2073.

[59] See T. D. 2752.

[60] Letter from Treasury Department dated November 26, 1917.

[61] T. D. 2752.

[62] In holding that a "call" was an "agreement to sell" under the 1898 Law the Supreme Court, in Treat v. White, 181 U. S. 264, pointed out the distinction between an "agreement to sell" and an "agreement of sale" as follows: "That there is a difference between an agreement to sell and an agreement of sale is clear. The latter may imply, not merely an obligation to sell, but an obligation

oranda of sales or deliveries of or transfers of legal[63] title to shares or certificates of stock in any association, company or corporation.[64] The tax is imposed whether or not the stock is represented by certificates,[65] and also whether or not the sale or transfer is shown by the books of the association, company or corporation, or is made by assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock[66] or not. The rate of this tax is 2 cents on each $100 of face value or fraction thereof unless the shares of stock are without par or face value, in which case the rate is 2 cents on each share unless the actual value thereof is in excess of $100 per share, in which case the tax is 2 cents on each $100 of actual value or fraction thereof.[67] The tax is measured, not by the amount paid in, on, or for, the stock but by the face or par value of the stock in the case of shares having a face or par value, and by the actual value determined by the market price or otherwise in the case of shares having no face or par value but an actual value in excess of $100 a share.[68]

on the part of the other party to purchase, while an agreement to sell is simply an obligation on the part of the vendor or promissor to complete his promise of sale. That Congress recognized the difference between these two terms is evident, because in the very next paragraph of Schedule A it provides, in reference to merchandise, for a stamp 'upon each sale, agreement of sale, or agreement to sell.' That no stamp duty was imposed on agreements to buy (or, in the vernacular of the stock exchange, 'puts') furnishes no ground for denying the validity of the stamp duty on agreements to sell.''

63 The word ''legal'' was first introduced in the 1917 Law and was not contained in the Act of October 22, 1914. Cf. § 270 of the New York State Tax Law and the case of Travis v. Ann Arbor Co., 180 N. Y. App. Div. 799.

64 The law uses the word ''corporation'' but see the definition of this term in Revenue Act of 1918, § 1.

65 T. D. 2752.

66 The Act of October 22, 1914, also read: ''or to secure the future payment of money or for the future transfer of any stock.''

67 Revenue Act of 1918, § 1107, Schedule A-4.

68 T. D. 2752.

Affixing and Cancellation of Stamps. In case the transfer is effected by delivery of the certificates of stock assigned in blank the stamp shall be affixed to the bill, memorandum, or agreement to sell. In case the change of ownership is by transfer of the certificate of stock, the stamp shall be affixed to the certificate, and in no event shall any company or registrar or transfer agent accept or transfer any shares of stock or certificates therefor unless stamps for all transfer tax required to be affixed to the certificate are attached thereto properly cancelled. In case the evidence of the transfer is shown only by the books of the company the stamp shall be placed upon the books. In the case of voting trust certificates stamps are affixed thereon upon surrender of the voting trust certificate.[69] In all other cases the payment shall be evidenced by affixing the stamp upon the memorandum or agreement of sale to be delivered by the seller to the buyer. The person using or affixing a stamp must cancel the same in the manner indicated in a preceding paragraph of this chapter.[70]

Stock of Domestic Corporations. The tax attaches to the transfer of stock on the books of a domestic corporation, no matter where the sale is made or the stock certificates are delivered.[71] This ruling was made in the case of stock transferred in Cuba by a Delaware corporation, all of whose operations were carried on in Cuba.

Stock of Foreign Corporations. When certificates of stock of a foreign corporation are sold or delivered within the United States they are subject to the same tax as certificates of stock of a domestic corporation.[72]

Where Title to the Stock Passed Prior to the Incidence of the Tax. No tax is imposed upon the transfer

69 Letter from Treasury Department dated May 22, 1918; W. T. S. 1918, ¶ 3722.

70 Reg. No. 40, Part 1, Art. 7. See paragraph on cancellation of stamps, supra.

71 Letter from Treasury Department dated July 24, 1918; W. T. S. 1918, ¶ 3743. See Page 812.

72 T. D. 2073.

of such stock on the books of a corporation although made after the date on which the tax was first imposed.[73]

TAX PAID BUT ONCE. Where shares of stock are sold and the tax has been paid and stamps affixed to a bill or memorandum of sale, stamps are not again required when the transfer is made on the books of the company from the name of the party selling to the name of the purchaser.[74]

SHARES OR CERTIFICATES OF STOCK. The law imposes this tax on all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to "shares or certificates of stock or of profits or of interest in property or accumulations in any corporation, or to rights to subscribe for or to receive such shares or certificates."[75]

RIGHTS TO SUBSCRIBE FOR STOCK. Under the present law, rights to subscribe for or to receive shares or certificates of stock (or of profits or interest in property or accumulations) in any corporation are expressly made subject to tax.[76]

RIGHTS TO RECEIVE STOCK DIVIDENDS. The transfer of a right to receive a stock dividend already declared is taxable.[77]

MASSACHUSETTS TRUSTS. The tax on the transfer of capital stock applies to the transfer of shares in so-called Massachusetts Trusts and other unincorporated associations.[78]

73 Letter from Treasury Department dated November 30, 1917; W. T. S. 1918, ¶ 3574. This was also the rule under the 1914 Law.

74 T. D. 2073.

75 Revenue Act of 1918, § 1107, Schedule A-4.

76 Revenue Act of 1918, § 1107, Schedule A-4. Under the former law, it was first held that such rights were included in the definition of the term "share or shares of stock" (Letter from Treasury Department dated March 12, 1915) and later that the tax did not apply to the transfer of rights to subscribe for stock prior to the exercise thereof and actual subscription (Reg. No. 40, Part 1, Art. 1; T. D. 2752). It was held under the 1914 Law that transfers of such rights were not taxable.

77 T. D. 2752.

78 T. D. 2752.

Shares Without Par Value. The law provides that the tax shall be imposed at the rate of 2 cents a share on shares without par or face value, unless the actual value of the share is in excess of $100, in which case the tax is 2 cents on each $100 of such actual value or fraction thereof. The actual value is measured by the market price at the time of the sale or transfer, which value is considered by the Treasury Department to be the actual value.[79]

Transfer of Stock Before Issue of Certificate. The existence of a stock certificate is not essential in order to make the transfer of shares subject to the tax. A transfer affecting a change of ownership of the share whether made before or after the issuance of the original certificates is taxable.[80] Under the 1914 Law it was held that transfers of subscription warrants entitling the holder to certificates of stock were taxable as transfers of stock.[81]

Loan of Certificates of Stock. The transfer of shares or certificates of stock in any association, company or corporation made by the person loaning stock to another borrowing the stock to effect a sale, and also the transfer of shares or certificates of stock from a borrower returning them to a lender in fulfilment of the borrower's obligation to buy in and return stock, are both subject to tax. In a so-called short sale transaction there are therefore four taxable sales or transfers: (1) The sale of stock by the person making the short sales; (2) The transfer from the lender of stock to the person making the short sale so that he may make delivery of the stock sold; (3) The purchase by the borrower of stock to return to the lender; (4) The transfer from the borrower to the lender of shares to replace those borrowed.[82]

79 T. D. 2752; letter from Treasury Department dated November 26, 1917, W. T. S. 1918, ¶ 3584. See Capital Stock, Issue.

80 T. D. 2752; T. D. 2599.

81 Letter from Treasury Department dated July 8, 1915.

82 T. D. 2685. Under the 1914 Law, certificates so loaned were not held taxable. (T. D. 2182.)

STOCK REDEEMED BY THE ISSUING CORPORATION. The tax on the transfer of capital stock does not apply to the surrender of stock certificates for retirement and redemption for cash. If, however, the corporation buys some of its own stock and transfers it to itself, whether or not it intends eventually to cancel it, the transfer to the corporation is subject to tax. The test is whether the immediate transaction results in the extinction of the stock or investing title to it in the corporation.[83]

VOTING TRUST CERTIFICATES. It has been held that: (1) The transfer of stock from stockholders to voting trustees is subject to tax, (2) the receipt of the certificates given by the voting trustees to the stockholders is not subject to tax, (3) any sale or transfer of such voting trust certificates by the owner is subject to tax, (4) the transfer by the voting trustees to the stockholders at the termination of the voting trust agreement is subject to tax.[84]

STOCKHOLDERS' COMMITTEES. A transfer of stock by individual stockholders to a committee of stockholders under a deposit agreement is subject to the stock transfer tax.[85] Transfers of certificates of stock to stockholders' committees for the protection of stockholders pending the receivership of a corporation are subject to tax.[86]

TRANSFERS TO AND BY FIDUCIARIES. Transfers of legal title are taxable whether or not the transferee acquires

[83] T. D. 2752; Letter from Treasury Department dated June 20, 1918; W. T. S., 1918, ¶ 3732. Under the 1914 Law it was held that where stock was redeemed by a corporation the transfer from the stockholder to the corporation was subject to tax whether or not the stockholder merely surrendered the certificate for cancellation or executed the assignment on the back of the certificate. (Letter from Treasury Department dated January 20, 1916.)

[84] Reg. No. 40, Part 1, Art 1; Letter from Treasury Department dated May 22, 1918; W. T. S. 1918, ¶ 3722. See letter from Treasury Department, dated January 7, 1915, for rulings as to voting trust certificates under the 1914 Law.

[85] Letter from Treasury Department dated April 30, 1918; W. T. S. 1918, ¶ 3721.

[86] Letter from Treasury Department dated January 28, 1919; W. T. S. 1918, ¶ 3760.

any beneficial interest in the stock transferred. Thus, transfers from one trustee to another trustee under the same trust are subject to tax [87] and it would seem that transfers of stock standing in the name of a deceased person to his executor or administrator, transfers from an executor or administrator to a trustee, and transfers from a trustee to the beneficiary under the trust are all taxable, under the present law.[88]

OTHER TRANSFERS WHERE CHANGE OF LEGAL TITLE ONLY TAKES PLACE. It has ben recently held under the Stock Transfer Tax Law of New York (the language of which is similar to that of the federal law) that stock transfer taxes accrue upon the cancellation and surrender of a stock certificate standing in the name of an accommodation holder (nominal stockholder) and the making out of a new certificate in the place thereof in the name of another accommodation holder, and the endorsement of the new certificates in blank by the latter, the actual ownership of the stock at all times remaining in the same person. As there were two transfers of the legal title, two taxable transfers took place and a tax was required to be paid on each.[89]

[87] Letter from Treasury Department dated July 12, 1918; W. T. S. 1918, ¶ 3741.

[88] Under the 1914 Law it was held that transfers from a deceased to his executor or administrator were not taxable. Transfers from a trustee to a substitute trustee were not taxable. Transfers from an executor or administrator to a trustee were taxable as were also transfers from the trustee to the beneficiary under the trust. It is to be noted that the words "legal title to" have been added to the Act of October 3, 1917 (see note 63 of this chapter), and therefore the fact that the trustee or nominee who transfers stock, and the party to whom title is transferred, both represent the same estate or beneficiary, does not affect the question, so long as the *legal title* is transferred. (Letter from Treasury Department dated July 12, 1918; W. T. S. 1918, ¶ 3741.)

[89] Section 270 of the New York State Tax Law. Travis v. Ann Arbor Co., 180 N. Y. App. Div. 799. The court said in this case: "The application of any other rule would be opposed to the plain wording of the statute, and furnish in many cases an easy method of evasion of the tax."

FORMAL TRANSFERS WHERE NO CHANGE OF TITLE TAKES PLACE. The act does not seem to contemplate a tax unless there is a transfer of legal title to the shares or certificates. Therefore, the tax on transfers of stock is not applicable to the surrender of old stock in exchange for new stock pursuant to a reorganization of a corporation under Section 24 of the New York Stock Corporation Law for the purpose of issuing stock without par value.[90] The tax on transfers of stock does not attach to the exchange of stock certificates of the merged corporation for stock certificates of the merging corporation at the time and as a part of the merger of trust companies under Sections 487-496 of the New York Banking Law, nor to the substitution of new certificates for certificates representing old stock of the merging corporation.[91] Where, however, as under Section 15 of the New York Stock Corporation Law, providing for the merger of ordinary corporations, the acquisition of the stock of the corporation to be merged is a condition precedent to the merger, then the transfer of such stock to the merging corporation prior to the actual merger is taxable.[92] In the case of a consolidated corporation issuing stock in exchange for the stock of consolidating corporations the surrender of the stock of the consolidating corporations in exchange for the stock issued by the consolidated corporation is not a taxable transfer.[93] The tax does not apply to the surrender of certificates in exchange for other certificates representing the same or new stock, provided they are issued to the same holder,[94] and no tax attaches to the surrender of common stock certificates in exchange for preferred stock certificates if there be no change of ownership. But when a corporation changes a portion of its common stock issue into preferred stock, share for share, such issue of preferred stock, being

[90] T. D. 2752.
[91] T. D. 2752.
[92] T. D. 2752.
[93] T. D. 2752.
[94] T. D. 2752.

an original issue of stock different in kind from the old stock, is subject to the tax on original issue.[95] Some rulings made under the 1914 Law touching this subject are stated in the footnote below.[96]

DEPOSIT OF STOCK CERTIFICATES AS COLLATERAL SECURITY. No tax is intended to be imposed upon an agreement evidencing a deposit of stock certificates as collateral security for money loaned thereon, which certificates are not actually sold, nor upon the delivery or transfer for such purpose of such stock certificates so deposited.[97] Under the 1914 law it was held that no tax was imposed on stock deposited as collateral until complete title to the certificates of stock was acquired by the pledgee.[98] This seems also to be the rule under the present law.

TRANSFERS TO OR BY A BROKER. No tax is imposed upon deliveries or transfers to a broker for sale, nor upon deliveries or transfers by a broker to a customer for whom and upon whose order he has purchased the same, but such deliveries or transfers shall be accompanied by a certificate setting forth the facts.[99]

CERTIFICATE BY BROKER. The following forms have been prescribed for the use of brokers: (a) (in the case of a transfer to a broker) "We hereby certify that we have no ownership, or interest, in * * * shares of the stock above transferred, the transfer by the owner to us being

95 Letter from Treasury Department dated June 11, 1918; W. T. S. 1918, ¶ 3730.

96 Where a new corporation was formed for the purpose of reorganization, the stock certificates of the new company were held subject to tax as original issue but the exchange of certificates of the old company for certificates of the new company to the same person were held not taxable as transfers. In the case of a merger it was held that the exchange of stock of the old companies for stock of the new company resulting from the merger were not subject to the transfer tax. (Letter from Treasury Department dated June 10, 1916.)

97 Revenue Act of 1918, § 1107, Schedule A-4. See Reg. No. 40, Part I, Art. 5.

98 Letter from Treasury Department dated December 28, 1915.

99 Revenue Act of 1918, § 1107, Schedule A-4.

merely for the purpose of sale," (b) (in the case of a transfer by a broker) "We hereby certify that the transfer of * * * of the within shares to the names indicated by the star is made solely to complete the purchase made by us for our customer, and we have no ownership or interest therein." No broker who has filed a certificate under the foregoing clause (a) of this ruling should file a certificate under the foregoing clause (b) with reference to the transfer of any shares of stock covered by the certificates filed by him under clause (a).[100]

TRANSFERS TO CLEARING HOUSE. No tax is imposed upon transfers or deliveries to a clearing house for the sole purpose or clearing or adjusting accounts between members, where no beneficial interest is vested in said clearing house or clearing association and there has been no change of title or interest: *Provided,* the exchange, by appropriate by-laws or regulations, requires from its members that all transactions of such members in shares of stock be promptly reported to such clearing house to the end that the stamp taxes thereon may be collected and that no other clearances or settlements or trading in balances are permitted.[101]

TRANSFERS TO OR BY ALIEN PROPERTY CUSTODIAN. A transfer to the Alien Property Custodian of shares or certificates of stock in compliance with a demand made by him under authority of the Trading With the Enemy Act is the performance of a mandatory obligation, not voluntarily assumed, but imposed by the paramount authority of the Government and is therefore held not subject to the stamp tax. A sale by the Alien Property Custodian of shares or certificates of stock under the authority of the Trading With the Enemy Act, his agreement so to sell, and his transfer of legal title to certificates or shares so sold by him are held to be governmental acts in the admin-

100 Reg. No. 40, Part I, Art. 5.
101 Reg. No. 40, Part I, Art. 5.

istration of the Trading With the Enemy Act and therefore not subject to the stamp tax.[102]

MEMORANDUM OF SALES. Every person who makes sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of the legal or beneficial title to shares of stock, at, in or on any exchange or similar place of business, and every person who makes any agreement to sell stock or makes a transfer of stock by delivery of the certificate therefor assigned in blank, must as a part of every such transaction, promptly make and deliver to the buyer a bill, or memorandum of sale, or agreement to sell, duly signed by the principal or his agent, which shall show the date of the transaction evidenced by it, the names of the seller and buyer, the shares of stock to which it relates, the number of shares and the price per share of said stock, and shall bear a number upon the face thereof. No more than one such bill or memorandum made by the seller on any given day may bear the same number; *Provided, however,* that no single transaction of a purchase or sale that is made upon an exchange by one member for another member shall require to be evidenced by more than one stamped memorandum of sale or agreement to sell.[103]

REGISTRATION OF STOCK BROKERS. Stock brokers, transfer agents and clearing houses are required to register with the collector of internal revenue and to keep records

[102] T. D. 2786.

[103] Reg. No. 40, Part I, Art. 6. In McClain v. Fleishman, 106 Fed. 880, a stock broker entered into agreement with his customers to buy and sell stocks on a fixed price for future delivery. Each of such agreements was evidenced by the written memoranda properly stamped in accordance with the 1898 Law. The transfers were purely speculative, conducted on margins and no actual delivery was contemplated by the parties, settlement being made by a payment of differences and the surrender of the written memoranda. It was held that such settlements did not involve agreements for a resale of the stocks requiring new memoranda to be made and stamped, the court having no authority to infer such agreements contrary to the fact for the purpose of extending statutory provisions to transactions not within its terms.

of sales and transfers as is more fully set forth in a subsequent part of this chapter.[104]

Certificates of Profits. The 1898 Law and the 1914 Law taxed the original issue of a "certificate of profits, or any certificate or memorandum showing an interest in the property or accumulations of any association, company, or corporation, and on all transfers thereof." The 1917 Law was silent. The present law taxes the original issue of "certificates of * * * profits, or of interest in property or accumulations, by any corporation"[105] and the sale or transfer of legal title to "certificates * * * of profits or of interest in property or accumulations in any corporation."[106] In the 1918 Law the term "corporation" includes associations, joint-stock companies, and insurance companies. It seems, therefore, that certificates of profits or interest in property or accumulations are not taxed on original issue unless issued by a corporation, association, joint-stock company or insurance company, but the sale or transfer thereof may be taxed, if the certificate evidences an interest in the profits, property or accumulations of a corporation, association, joint-stock company or insurance company, regardless of who may have issued it. Thus, voting-trust certificates are not taxable on original issue, if they are issued by a trustee, but are subject to the tax on transfers when sold or transferred by the owner. Under the 1914 Law it was held that certificates issued by trustees to persons who had deposited certain securities, showing such persons to be entitled to a part of the dividends accruing on account of the securities deposited were liable to the tax upon certificates of profit.[107] Under the present law the issue of voting trust certificates would not be taxable, but the sale or transfer thereof would be taxable.

Certificates of Deposit. Certificates of deposit issued by banks and trust companies are not considered to be tax-

104 See pp. 851, 852, 854.
105 Revenue Act of 1918, § 1107, Schedule A-3.
106 Revenue Act of 1918, § 1107, Schedule A-4.
107 Letter from Treasury Department dated July 26, 1916.

able as certificates of indebtedness, whether or not they are time certificates, or contain a clause reserving the right of thirty days' notice of payment.[108]

Certificates of Indebtedness. A "certificate of indebtedness' is primarily any instrument acknowledging liability for the payment of money, not in the recognized form of a promissory note or bill of exchange.[109] See bonds of indebtedness.

Certificates of Stock. See capital stock.

Certificates Generally. No tax is imposed under the present law on certificates of incorporation, certificates of damage and certificates generally.

Checks. No tax is imposed on checks payable at sight or on demand. Drafts or checks payable otherwise than at sight or on demand are taxable at the same rate as promissory notes. See promissory notes.

Contracts. No tax is imposed by the present law on contracts as such.[110]

Conveyances. The law taxes any deed, instrument or writing, whereby any lands, tenements, or other realty *sold* shall be granted, assigned, transferred or otherwise conveyed to, or vested in, the purchaser or purchasers, or any other person or persons, by his, her or their direction. The tax is based upon the consideration or value of the interest or property conveyed, exclusive of the value of any lien or incumbrance *remaining thereon at the time of sale.*[111] The rate is as follows: When such consideration or value does not exceed $100, no tax; exceeding $100 and not exceeding $500, 50 cents; for each additional $500 or fractional part thereof, 50 cents. The tax does not apply to any instrument or writing given to secure a debt.[112]

108 Letter from Treasury Department dated November 16, 1917; W. T. S. 1918, ¶ 3568.

109 T. D. 2713.

110 T. D. 2599.

111 Revenue Act of 1918, § 1107, Schedule A-7. See Central Trust Co. v. Columbus etc. Co., 92 Fed. 919.

112 Revenue Act of 1918, § 1107, Schedule A-7.

Who Affixes Stamps. The person who executes the deed (i. e., the grantor) is required to affix the stamps thereto and becomes primarily liable to penalty if stamps in a sufficient amount based upon the actual value of the consideration given are not so affixed.[113] Where a purchaser has accepted an unrecorded deed he may be compelled to pay the required tax before having the deed recorded, or prosecuted under Section 1102 of the law.[114] In a case where the referee at a foreclosure sale did not affix the stamps required by law but the purchaser affixed such stamps under protest before recording the deed, it was held that the grantee, vendee or any other person participating in the making or issuing of a paper without revenue stamps may be required to pay the tax thereon and is liable for failure to do so.[115]

When Stamps Affixed. It seems that the stamps should be affixed at the time of delivery of the deed. It was held under the 1914 law that a deed in escrow does not become subject to the tax until the final delivery is made. If such delivery is made subsequent to the incidence of the tax it becomes subject to the tax.[116] A deed executed and delivered prior to the incidence of the tax is not subject to the tax although recorded after that date.[117] Deeds delivered after the incidence of the tax must be stamped although they may have been dated, executed and acknowledged prior thereto and even though delivered prior thereto to a third party for account of the grantee named in the deed, if delivery by such party to the grantee is made after the incidence of the tax.[118]

113 T. D. 2115, T. D. 2283.

114 See Page 865, also letter from Treasury Department dated May 27, 1918. W. T. S. 1918, ¶ 3723.

115 T. D. 2310; Home Title Insurance Company v. Keith, 230 Fed. 905.

116 T. D. 2115. So also held in Vol. 2, Treas. Dec. (1898) No. 20096.

117 T. D. 2115.

118 T. D. 2042.

WHERE STAMPS ARE AFFIXED. The stamps should be affixed on the deed or other instrument conveying the real estate.[119]

REALTY SOLD. The law provides that deeds whereby any realty sold shall be conveyed to another are taxable. Hence, it seems that if the realty is not sold, no stamps need be affixed to the deed. The word "sold" is used in its ordinary meaning and acceptation. There must be a transfer of a valuable interest in the property or payment of a consideration. Thus it has been held under preceding laws that deeds that are simply confirmatory and do not vest title not already vested are not taxable.[120] The following kinds of deeds are also not taxable: (1) quit-claim deeds given for no consideration, or merely for the nominal consideration of $1.00, for the purpose of correcting flaws in title,[121] (2) partition deeds which are operative in defining boundary lines or in showing by location the interests of the tenants-in-common,[122] (3) deeds of release,[123] (4) deeds of trust,[124] (5) deeds issued to cover gifts of property from husband to wife or from parent to child, or from an individual to a municipality or other political subdivision, wherein the consideration named is "natural love and affection and $1.00," "desire to promote public welfare and $1.00," or "$1.00 and other valuable consideration,"[125] (6) deeds not granting, assigning, transferring or conveying to the purchasers any lands, tenements, or other realty, but only the right to burial, to erect monuments, etc.,[126] (7) deeds of reconveyance by an agent to an undisclosed principal if no consideration, or a nominal consideration of

119 T. D. 2599.

120 Circular No. 503, 2d revision. Compilation of decisions for year 1899, Page 293.

121 T. D. 2115.

122 T. D. 2115.

123 T. D. 2115.

124 T. D. 2115.

125 T. D. 2115.

126 T. D. 19838.

$1.00 only is given, (8) deeds executed by debtors covering assignments of property to trustees to be held for the benefit of creditors,[127] (9) deeds given by a husband and wife to a "straw man" who immediately executes a deed reconveying the property to the husband or wife, if no valuable consideration, or merely the nominal consideration of $1.00 is given, and likewise the deeds of reconveyance,[128] (10) deeds transferring title to property to building and loan associations for the purpose of securing a loan on the property so conveyed, which property is immediately reconveyed to its owner, and likewise the deeds of reconveyance.[129]

CONSIDERATION OR VALUE. The tax is imposed upon the full amount of consideration or value although payments may have been made upon the installment plan prior to the incidence of the tax.[130] Quit-claim deeds are taxable according to the value of the interest conveyed.[131] Stock in a corporation is a valuable consideration for the transfer of real property, and a deed conveying real estate to a corporation for such consideration is taxable. The value of the interest in the property conveyed determines the amount of the tax.[132] Where a deed states that the transfer is made for a nominal consideration the tax must be computed upon the actual value of the interest or property conveyed.[133] In a case of an exchange of two properties the deeds transferring title to each are subject to tax, which should, in each case, be computed on the basis of the actual value of the interest or property conveyed (exclusive

127 T. D. 2115. When, however, the trustee sells or conveys such property either to the creditor, or any other person, the deeds executed by him are taxable. (T. D. 2115.)

128 T. D. 2115.

129 T. D. 2115.

130 T. D. 2279.

131 T. D. 20232.

132 T. D. 2278.

133 T. D. 2115.

of the value of any lien or incumbrance remaining thereon at the time of exchange).[134]

INCUMBRANCE ON PROPERTY AT THE TIME OF SALE. The consideration or value on which the tax is based is exclusive of the value of any lien or incumbrance *remaining* thereon *at the time of sale*. The words in italics were not contained in the former law and it seems were inserted to limit the exclusion to liens or incumbrances other than purchase money mortgages. In determining the amount of incumbrances upon real estate being transferred, no consideration is to be given to new incumbrances placed upon same at the time of, or after, the sale. Only incumbrances which rest on the property before the sale and which are not removed by the sale are to be taken into consideration.[135]

CONTRACTS TO CONVEY. A contract for the sale of real estate, making provision for future delivery by deed, is not subject to stamp tax.[136]

MINING DEEDS. A conveyance of a mine located on unpatented land is subject to taxation.[137] The foregoing ruling was made under the 1898 Law. Under the 1914 Law, it was held by the Treasury Department in an informal ruling that deeds to mining claims prior to the issue of the patent were taxable upon transfer as conveyances of real property. The tax should be computed upon the interest in the property conveyed which would be the market value of the stock issued therefore, or if it had no market value, the cash value of the mining claim.[138]

TIMBER DEEDS. Standing timber is ordinarily held to be real estate. The question of whether or not a particular instrument of grant is taxable depends on whether or not the subject matter of the grant is real estate. What is real estate is determined by the law of the state in which the property conveyed is situated. It is held that a timber

134 T. D. 2111, T. D. 2599.
135 T. D. 2599.
136 T. D. 2599, T. D. 2115.
137 Vol. 1, Treas. Dec. (1899), No. 20986.
138 Letter from Treasury Department dated August 3, 1916.

deed transferring the timber upon a tract of land is a deed of realty and as such is taxable unless timber is not real estate under the laws of the state in which the property is located.[139]

LEASES. Oil leases, leases of mining property, long-term mining leases, etc., which, in themselves, convey no title to, or interest in, real property are exempt from taxation.[140]

OPTIONS. No tax is imposed upon an option for the purchase of real property.[141]

PROPERTY IN A FOREIGN COUNTRY. A deed of conveyance conveying real estate that lies in countries that are not United States territory is not subject to taxation, though the grantor and grantee may both be citizens and residents of the United States.[142]

DEEDS GIVEN BY UNITED STATES AND POLITICAL SUBDIVISIONS. Deeds executed by the United States or by any State, county, town or other municipal corporation are not taxable.[143]

DEEDS GIVEN BY OFFICERS OF COURTS. Stamps should be attached to masters' deeds made pursuant to decree of United States District Courts. The execution of the conveyance is not a judicial function, the title to the land being conveyed to the purchaser at the foreclosure sale through the master instead of the defendant himself making the deed. The cost of stamps should be taxed as part of the costs of the case.[144]

CONVEYANCE TO OR BY ALIEN PROPERTY CUSTODIAN. A conveyance of realty to the Alien Property Custodian in compliance with a demand made by him under authority

139 Letter from Treasury Department dated February 15, 1918; W. T. S. 1918, ¶ 3685.

140 T. D. 2155, T. D. 2599.

141 T. D. 2115.

142 Vol. 2, Treas. Dec. (1898), No. 21562. It was also so held under the Act of October 22, 1914.

143 T. D. 2283. See Revenue Act of 1918, § 1101.

144 T. D. 2111, T. D. 2253; Crawford v. New South Farm & Home Company, 231 Fed. 999. This case was decided under the 1914 Law, and it was held that the decision in Farmers' Loan and Trust Com-

of the Trading with the Enemy Act, is held not subject to the stamp tax for the reason that such a conveyance is the performance of a mandatory obligation, not voluntarily assumed, but imposed by the paramount authority of the government, and for the further reason that it is not a conveyance of "realty sold." A conveyance by the Alien Property Custodian of realty sold by him under authority of the Trading with the Enemy Act is held not to be subject to the stamp tax for the same reason, and for the further reason that it is an instrument issued by the United States in the exercise of a strictly governmental function.[145]

Debentures. The term "debenture" ordinarily, although not necessarily, refers to an unsecured bond.[146] See bonds of indebtedness.

Deeds. See conveyances.

Drafts. Drafts drawn at sight or on demand are not taxable.[147] Drafts drawn in foreign countries and paid within the United States are not taxable.[148] But drafts drawn otherwise than on sight are generally taxable. The taxability of a draft is determined by the face or form of the instrument and not by any understanding between the maker and the drawee.[149] For rate of tax and a discussion of the rulings regarding taxable drafts see Promissory Notes.

Entry for Withdrawal of Goods or Merchandise from Customs Bonded Warehouse. The tax on instruments of this character is 50 cents.[150] Under the 1914 Law it was held that withdrawals for exportation were not taxable in view of the constitutional provision prohibiting taxation

pany v. Council Bluffs Gas & Electric Company, 90 Fed. 806, decided under the 1898 Law, was applicable.

145 T. D. 2786.

146 T. D. 2713.

147 Revenue Act of 1918, § 1107, Schedule A-6.

148 Letter from Treasury Department dated November 27, 1917.

149 See Note 205, p. 844.

150 Revenue Act of 1918, § 1107, Schedule A-9.

upon exports.[151] It was also held that where entries were filed in duplicate, triplicate, etc., a stamp was required on the original only.[152]

Entry of Goods, Wares or Merchandise at Customhouse. The law provides that entry of any goods, wares or merchandise at any custom-house, either for consumption or warehousing, shall be taxed as follows: Not exceeding $100 in value, 25 cents; exceeding $100 and not exceeding $500 in value, 50 cents; exceeding $500 in value, one dollar.[153] Under the 1914 Law it was held that entries covering merchandise imported solely for governmental purposes were not taxable nor were entries covering merchandise imported for the benefit of foreign ministers, ambassadors or their attaches, even though the entries covering such articles were made by customs brokers.[154]

Fidelity Insurance. See Bonds of Indemnity and Surety.

Guarantee Insurance. See Bonds of Indemnity and Surety.

Insurance Policies. A tax of 5 cents on each dollar or fractional part thereof of the premium charged is imposed on each policy of insurance or certificates, binder, covering, note, memorandum, cablegram, letter or other instrument by whatever name called whereby insurance is made or renewed upon property within the United States (including rents and profits) against peril by sea or on inland waters or in transit on land (including transshipments and storage at termini or way points) or by fire, lightning, tornado, wind-storm, bombardment, invasion, insurrection or riot, issued to or for or in the name of a domestic corporation or partnership or an individual resident of the United States by any foreign corporation

151 T. D. 35007. See U. S. v. Hvoslef, 237 U. S. 1, and paragraph on Constitutionality of Stamp Taxes.

152 T. D. (Customs) 35040. See Wright v. Michigan Central Co., 130 Fed. 843.

153 Revenue Act of 1918, § 1107, Schedule A-8.

154 T. D. (Customs) 35072.

or partnership or any individual not a resident of the United States, when such policy or other instrument is not signed or countersigned by an officer or agent of the insurer in a State, Territory, or district of the United States within which such insurer is authorized to do business. Policies of re-insurance are exempt from this tax.[155] It is probably not anticipated that any considerable revenue will be collected by virtue of this tax, and it seems to be intended to compel non-resident foreign corporations and partnerships and non-resident individuals, in respect to policies of insurance on property within the United States issued to domestic corporations or resident partnerships or individuals, to pay the lower tax on insurance policies imposed by Section 503 of the Revenue Act of 1918, which they have hitherto been escaping.

WHO AFFIXES STAMP. Any person to or for whom or in whose name any such policy or other instrument is issued, or any solicitor or broker acting for or on behalf of such person in the procurement of any such policy or other instrument shall affix the proper stamps to such policy or other instrument.[156]

Interim Certificates. See Capital Stock.

Leases. Leases are not taxed under this law.

Mortgages. Mortgages are not taxed under this law.

Mutual Ditch and Irrigating Companies. Stocks and bonds issued by mutual ditch or irrigating companies are not taxable.[157] The law seems to exempt stock of such companies from the tax on the issue thereof, and also from the tax on sale or transfers. The exemption does not extend to notes or any other instruments except certificates of stock and bonds.

Original Issue of Stock. See Capital Stock, Issue.

Parcel-Post Packages. The tax is imposed upon every parcel or package transported from one point in the United States to another by parcel post on which the postage

155 Revenue Act of 1918, § 1107, Schedule A-15.
156 Revenue Act of 1918, § 1107, Schedule A-15.
157 Revenue Act of 1918, § 1101.

amounts to 25 cents or more. The tax is at the rate of 1 cent for each 25 cents of postage or fractional part thereof. The law requires the tax to be paid by the consignor. It is to be noted that the tax is only on parcels and packages transported from one point to another in the United States. Packages transported to foreign countries are not taxable. Packages transported from this country to Porto Rico or other possessions are not taxable and packages transported from one point to another in such possessions are not taxable.[158]

Passage Tickets. The tax on passage tickets is only imposed on tickets sold or issued in the United States for passage by any vessel to a port or place not in the United States, Canada or Mexico. Such tickets are required to be stamped whether they are one-way or round-trip. No tax is imposed on tickets costing $10 or less. The intent seems to be to impose a tax for each passenger based upon the cost of the ticket. The rate is one dollar if the cost of the ticket does not exceed $30; $3 if the cost of the ticket exceeds $30 and does not exceed $60, and $5 if the cost of the ticket exceeds $60.[159] Where a single ticket is issued for transportation for more than one passenger the ticket, coupon or prepaid order must be stamped at the proper rate for each passenger based on the number of passengers, and the total amount paid for the transportation.[160] It is the duty of the person selling the ticket to affix the stamp to the ticket or paper which evidences the sale and cancel the stamp.[161] Under preceding stamp tax laws it has been held that tickets used by members of foreign diplomatic corps were not required to be stamped.[162]

Playing Cards. A tax of 8 cents per pack is imposed upon every pack of playing cards containing not more than fifty-four cards, manufactured or imported, and sold

158 Revenue Act of 1918, § 1107, Schedule A-14. See T. D. 2599.
159 Revenue Act of 1918, § 1107, Schedule A-10.
160 T. D. 2067.
161 T. D. 2067.
162 Vol. 2, Treas. Dec. (1898), No. 20196.

or removed for consumption or sale.[163] The statute contains extensive provisions as to the rates of tax to be imposed and the liability of the vendee in cases where contracts have been made in the past by which the vendor is otherwise prevented from passing the tax on to the purchaser.[164] It has been held that the statute imposing a tax on playing cards requires that each pack of cards shall show a stamp denoting a payment of the tax, and a dealer, therefore, may not reassemble the cards from packs on which the stamp tax has been paid and then offer the reassembled packs for sale in new wrappings without restamping.[165]

Powers of Attorney. Powers of attorney are taxable instruments under this law if they are such that they grant authority to do or perform some act for or in behalf of the grantor, which authority is not otherwise vested in the grantee. The rate of tax is 25 cents. The law expressly provides that no stamps shall be required on any papers necessary to be used for the collection of claims from the United States or from any State for pensions, back pay, bounty, or for property lost in the military and naval service.[166] Powers of attorney required in bankruptcy cases are also expressly exempted.[167]

WHEN TO AFFIX STAMPS. The tax on a power of attorney is due when the instrument is executed and is made

163 Revenue Act of 1918, § 1107, Schedule A-13. This tax was 5 cents upon every pack under the Act of October 3, 1917, but such tax of 5 cents was "in addition to the tax imposed under (then) existing law." (Act of October 3, 1917, § 807, Schedule A-13.) The tax of 8 cents per pack is not additional or supplementary, as was the tax imposed by the 1917 Law.

164 Revenue Act of 1918, § 1312 (1), (2), (3).

165 U. S. v. Neustaedter, 149 Fed. 1010.

166 Revenue Act of 1918, § 1107, Schedule A-12.

167 This express exemption seems to have been introduced in the 1917 Law as a result of the decisions in the cases of In re Hawley, 220 Fed. 372, which held that a general letter of attorney in bankruptcy was taxable under the 1914 Law, and in In re Capitol Trading Company, 229 Fed. 806, which held bankruptcy powers of attorney taxable under the 1914 Law.

valid by acceptance, and not when the power is exercised.[168] A power of attorney containing a power of substitution requires only one 25 cent stamp.[169] A certified copy of a power of attorney, such as is required to be filed on cards in the executive departments of the Government by various insurance and bonding companies, is not taxable.[170]

FORMAL POWERS OF ATTORNEY. Powers of attorney which are merely formal and grant no authority which is not otherwise vested in the grantee are not taxable. Thus, it has been held that no tax is imposed upon powers of attorney in the following cases:

ASSIGNMENT OF INSURANCE POLICIES. No stamp tax is imposed upon the power of attorney contained in a transfer by assignment, absolute or as collateral security, of an interest in a contract of insurance, if the power of attorney grants authority to do or perform only such acts for or in behalf of the assignor as are otherwise vested in the assignee.[171]

TO PAY POLL TAXES. Powers of attorney issued in accordance with the provisions of State statutes authorizing a person to pay a poll tax of an individual are not required to be stamped.[172]

POWER OF SALE. The power of sale generally embodied in a mortgage, real or chattel, and deed of trust, differs from a power of attorney in many respects, one of which is that the latter always creates an agency or a representative relation, whereas a mortgagee under a power of sale acts on his own behalf and for his own benefit. Such power of sale is not taxable as a power of attorney.[173]

POWER OF ATTORNEY TO TRANSFER STOCKS. *Pro forma* powers of attorney to transfer stocks or bonds on the books

168 T. D. 2134.
169 T. D. 2134.
170 T. D. 2134.
171 T. D. 2599.
172 T. D. 2269.
173 T. D. 2196.

of a corporation given to the purchaser upon the sale or transfer of such stocks or bonds are not taxable.[174]

POWER OF ATTORNEY GRANTED BY CORPORATION. Where a corporation by resolution of its Board of Directors has empowered an officer thereof to sell, assign or transfer stock or bonds standing in the name of the corporation, or to perform any act in the name of the corporation, such authority is not taxable as a power of attorney for the reason that it is necessary for a corporation to perform its corporate acts through one of its officers. If, however, a person other than an officer of the corporation acting in his official capacity is given this authority, the power of attorney so granted would require a 25 cent stamp. A general power of attorney granted by a Board of Directors to a person other than an officer of a corporation acting in his official capacity for the purpose of representing the corporation in transactions of a like kind and nature, such as conveying land or acknowledging deeds, is considered by the Treasury Department as specific authority for each individual transaction, and a revenue stamp is required on each instrument containing the power of attorney.[175]

JUDGMENT NOTES. Where judgment notes contain a clause authorizing any attorney of law to confess judgment in the favor of the holder of the note, such authorization is held not taxable as a power of attorney. The instrument is held to be a warrant of attorney instead of a power of attorney.[176]

POWER OF ATTORNEY EXECUTED OR ACCEPTED IN FOREIGN COUNTRY. A power of attorney executed by a person residing in a foreign country to a person in this country is taxable, as the instrument is not operative and effective until accepted by the person to whom the power is granted; and, for the same reason, a power of attorney

174 T. D. 2085, T. D. 2134.
175 T. D. 2134.
176 Treat v. Tolman, 113 Fed. 892; T. D. 2081.

executed by a person residing in this country to a person in a foreign country is not taxable.[177]

Produce, Sales of, on Exchange. The tax is imposed upon (a) sales of, (b) agreements of sale, and (c) agreements to sell[178] for future delivery[179] any products or merchandise at or under the rules or usages of[180] any Exchange or Board of Trade, or other similar place.[181] In a case arising under the 1914 Law it was held that offers to sell grain made subject to deferred acceptance, only a small percentage of which developed into sales and on which the brokers received only $10 for each ten thousand bushels sold, were taxable on the basis of the total price on which the seller agreed to sell rather than the basis of what the buyer was to receive; and also that the tax was imposed on each sale or agreement to sell any grain, though during the day several distinct and separate sales were made of the same grain and at the close of the day the only memoranda made showed a transfer from the original seller to the last buyer.[182] So-called transferred or scratch-sales are no longer taxed, being expressly stated not to be included.[183] No bill, memorandum, agreement or other evidence of a sale, or agreement of sale, or agreement to sell, in case of cash sales of products or merchandise for immediate or prompt delivery which in good faith are actually intended to be delivered are subject to this tax. When the seller of commodities

177 T. D. 2134.

178 See Treat v. White, 181 U. S. 264, and note 62.

179 The Act of October 22, 1914, provided for a tax on agreements either for present or future delivery but made an express exemption to cover cases where products or merchandise were actually delivered at the time of sale or were in vessel, boat or car and actually in the course of transportation.

180 The words "or under the rules or usages of" were added by the Revenue Act of 1918, § 1107, Schedule A-5.

181 Revenue Act of 1918, § 1107, Schedule A-5.

182 Calkins v. Smietanka, 240 Fed. 138.

183 So-called transferred or scratch sales were expressly included in the 1917 Law (Act of October 3, 1917, § 807, Schedule A-5). They were not mentioned expressly in the 1914 Law.

subject to this tax has paid the tax, he may transfer his contracts to a clearing house without paying a tax on such transfer if the transfer does not vest any beneficial interest in such clearing house association, but is made for the sole purpose of enabling the clearing house association to adjust and balance the accounts of its members on their several contracts. The rate is as follows: 2 cents for each $100 or fraction thereof in value of the merchandise covered by the sale or agreement of sale or agreement to sell.[184]

IMMEDIATE OR PROMPT DELIVERY. Cash sales of products or merchandise for immediate or prompt delivery which in good faith are actually intended to be delivered are not taxable.[185] "Immediate or prompt delivery" is held to mean delivery at once or as soon as practicable, and in any event within twenty days from the date of sale or agreement. Every sale or agreement not evdienced by a memorandum or contract expressly requiring immediate or prompt delivery within the above definition is deemed to be for future delivery. In all cases in which the Commissioner is not satisfied from the evidence submitted to him that the transaction was in good faith intended to be followed by immediate or prompt delivery, within the above definition, the seller will be required to pay the tax as on a sale for future delivery.[186]

EXCHANGE OR BOARD OF TRADE. The law taxes only sales at or under the rules or usages of an exchange or board of trade or other similar place.[187] The word "exchange" is held to mean every agency, auction place, or other meeting place at which produce or merchandise for future delivery is publicly bought, sold, bid for, offered, or exchanged, or contracts for such future delivery are made, either between the members or patrons of such exchange, or as between members and non-members, patrons,

[184] Revenue Act of 1918, § 1107, Schedule A-5.
[185] Revenue Act of 1918, § 1107, Schedule A-5
[186] Reg. No. 40, Part 2, Art. 4.
[187] Revenue Act of 1918, § 1107, Schedule A-5.

and the public. It includes all incorporated and unincorporated associations of individuals, partnerships, and corporations engaged in the business of publicly selling, buying or exchanging products or merchandise for future delivery.[188]

TRANSFERS TO CLEARING HOUSE. Sellers of products, merchandise or commodities having paid the tax provided by law may transfer such contracts to a clearing house association, and such transfer is not taxable within the provisions of the Act, provided that the transfer does not vest any beneficial interest in the clearing house associa-

[188] Reg. No. 40, Part 2, Art. 1. For a detailed consideration of the nature of an exchange or board of trade, see the case of Nicol v. Ames, 173 U. S. 509. This case went so far as to hold the Union Stock Yards to be a "similar place" within the meaning of the 1898 Law. No sales or purchases of stock were made by members of the Union Stock Yards Company as such. Anyone was accorded the right to bring his cattle to the stock yards upon payment of the regular fees and compliance with the regulations made by the company, and, having brought his cattle, he had the right accorded him by the company to have them kept, fed, watered, etc., and to sell them himself or by a commission merchant, who did not need to be a member of the Stock Yards Company. The court said: "It is plain to be seen that the privilege or facility for a sale of the cattle or other stock at the yards of such company is of precisely the same nature and character as that which exists at an exchange or board of trade which is so described in terms. That the sales are made by the owners of the cattle or by commission merchants who are not members of the stock-yards company, is not material. The facilities for a sale exist and are made use of in each case, and are in truth the same in each. A perusal of the facts contained in the record in the case shows that those yards answer all the purposes of an exchange or board of trade, and that they in truth amount in substance to the same thing. The differences existing between them are unsubstantial so far as this point is concerned. The sales at that place are accomplished with a facility which it is plain could not exist but for the conditions and advantages afforded by the use of those yards. The owner of the cattle who brings them to the yards and avails himself of the privilege of selling them at that place does without doubt make use of a privilege which everyone knows is an advantage sufficient to constitute a material difference between a sale at the yards and a sale elsewhere. This advantage, although one which any person could use, is yet of precisely the same nature as that existing

tion and is made for the sole purpose of enabling such clearing house association to adjust and balance the ac counts of its members on their several contracts.[189] A clearing house is defined to be any incorporated or unin corporated association carried on for the purpose of clearing, settling and adjusting transactions in purchasing, selling, receiving or delivering products or merchandise, whether such clearing house be a part or department of an exchange or an independent body.[190]

REGISTRATION AND RECORDS. All persons engaged in the business of making contracts of sale on any exchange and all clearing houses and members of exchanges are required to register and keep records of transactions subject to the tax. The rulings in this respect are referred to more fully in a subsequent part of this chapter.[191]

Promissory Notes. The law provides that the tax on promissory notes, and for each renewal of the same, for a sum not exceeding $100 shall be 2 cents; and for each additional $100 or fractional part thereof 2 cents. Drafts or checks payable otherwise than at sight or on demand are also taxable at the same rate.[192]

WHO AFFIXES STAMP. The person who makes or issues a promissory note is required by the law to place the stamp upon the same and cancel it. If he does not do so the holder or owner may affix and cancel the stamp as agent for the maker. If a draft is presented to the drawee for acceptance and discount by him, stamps must first be affixed by the drawer, for the acceptance and delivery are simultaneous. The payee or the indorsee from the drawer must see to it that the drawer, as the person "who

in the case of an exchange or board of trade, and it is therefore a similar place within the meaning of the statute. Being a similar place, the reasons stated in the foregoing cases apply with equal force here and demand the same judgment."

189 Revenue Act of 1918, § 1107, Schedule A-5.

190 Reg. No. 40, Part 2, Arts. 1 to 4.

191 See p. 859.

192 Revenue Act of 1918, § 1107, Schedule A-6.

makes, signs or issues" the draft, pays the tax before delivery. "Accept" is used in the penal provision in Section 1102 in the general sense of "receive," not in the special sense peculiar to drafts. No drawee accepting an unstamped undelivered draft would violate the law; but if the draft has already become taxable because of a prior delivery, the acceptor must be sure that stamps are affixed.[193]

RENEWAL OF NOTES. A renewal after the incidence of the tax of a note issued prior thereto is subject to tax.[194] A written agreement, either attached or unattached to a promissory note or in the form of an endorsement on the note, such as "renewed" or "extended" to a certain date, evidencing payment and acceptance of interest in advance to a time certain, subsequent to maturity, constitutes a renewal of the note and is subject to tax as such. On the other hand, part payment of a note after it becomes due, or payment of accrued interest after maturity, the note being allowed to run and the holder neither losing or postponing his right of action, is merely in the nature of a forbearance and is not taxable as a renewal.[195] A contract or agreement extending either a chattel or real estate mortgage is not taxable, but if such extension effects the renewal of promissory notes, either embodied in the mortgage or given in connection with the mortgage, the renewal of such notes is taxable.[196]

TRANSFER OF NOTES. No stamp is required upon the transfer by indorsement of promissory notes.

DEFINITION OF PROMISSORY NOTES. Whether or not an instrument is taxable as a promissory note depends upon its form and not upon its use. Thus, a receipt given by a loan company for property received as security for a

[193] T. D. 2682.

[194] Revenue Act of 1918, § 1107, Schedule A-6. Letter from Treasury Department dated December 11, 1917; W. T. S. 1918, ¶ 3679.

[195] Letter from Treasury Department dated June 14, 1918; W. T. S. 1918, ¶ 3742. See T. D. 2265.

[196] T. D. 2170.

debt is not a promissory note; but, if in the receipt there is included a promise to pay a certain sum of money at a specified time, with interest, for value received, such a provision in the opinion of the Treasury Department is a valid promissory note, upon which the maker would be liable in a suit at law, and is taxable.[197] Policy loan and premium extension agreements are not promissory notes as contemplated by the law and therefore are not liable to stamp tax.[198] In the case of contracts for the purchase of pianos, machinery, and other merchandise, there is sometimes included, among other conditions and provisions, an agreement to pay the vendor a stipulated sum of money at a certain time, with interest, for value received. If this agreement is in form and effect a good and valid promissory note, upon which the maker would be liable in a suit at law, such promissory note is taxable. If, however, the contract merely provides for the payment of the purchase price in installments and enumerates the dates upon which such payments are due, stating, as many of the contracts do, that in default of payment the vendor make take the property, such agreement is not a promissory note.[199] It is often difficult to make a distinction between promissory notes and bonds of indebtedness. Although in a broad sense many notes are bonds and many bonds are notes, obviously Congress did not intend to tax the same instrument under two heads.[200] An instrument, not under seal, containing a simple promise to pay a sum of money at a specified time, such as is common in everyday commercial use, is a promissory note.[201] It has been held, however, that the fact that a promissory note is under seal does not make it taxable as a bond.[202] A short term instrument, although issued by a corpora-

[197] T. D. 2170.
[198] T. D. 2599.
[199] T. D. 2170.
[200] T. D. 2713. See Paragraph on Bonds of Indebtedness.
[201] T. D. 2713. See Paragraph on Bonds Given in Penal Sum.
[202] T. D. 21815. (Act of June 13, 1898.)

tion under a trust indenture may be regarded as a note if every instrument of such issue both (a) is payable to bearer and incapable of registration and (b) lacks interest coupons, and so requires presentation upon each payment of interest.[203] Thus, the fact that a note may be secured by a mortgage or issued under a deed of trust does not necessarily make it taxable as a bond. One distinction between bonds and promissory notes seems to be the time for which the note or bond is to run. Promises to pay within a comparatively short period of time, such as one year or two years, are usually held to be taxable as notes while promises to pay at the end of a longer period are considered more in the nature of bonds or certificates of indebtedness. Coupon or interest notes attached to and forming a part of a bond or principal note are not subject to tax as promissory notes even though they are in the form of promissory notes.[204]

CHECKS OR DRAFTS PAYABLE OTHERWISE THAN AT SIGHT OR ON DEMAND. "The liability of an instrument to a stamp duty, as well as the amount of such duty, is determined by the form and face of the instrument, and cannot be affected by proof of facts outside of the instrument itself."[205] Unless the statute expressly so provides, drafts, acceptances, overdrafts, and postdated checks are not taxable as promissory notes, even though they perform some

[203] T. D. 2713.

[204] T. D. 2101. Kenosha v. Lamson, 9 Wall. 477; Lexington v. Butler, 14 Wall. 282.

[205] U. S. v. Isham, 17 Wall. 495. In Granby Co. v. Webster, 98 Fed. 604, decided under the 1898 Law, the court, following U. S. v. Isham (supra) explains the rule as follows: "Were it necessary to inquire into all the circumstances attending the execution of an order for the payment of money, before it can be ascertained whether it be liable to the stamp tax, endless delay would be occasioned. The purpose of the tax—the prompt relief of the treasury—would be defeated." Under the 1914 Law it was held that in view of the decision of U. S. v. Isham, drafts, acceptances, overdrafts, and postdated checks were not taxable as promissory notes, even though they were used in such a way as to perform some of the functions of a promissory note. (T. D. 2170.)

of the functions of a promissory note. It is no doubt in view of the decision above quoted that drafts and checks payable otherwise than at sight or on demand are by the present law expressly included in the same category as promissory notes. The general rule is that a draft or check delivered within the United States is subject to the tax *if expressed* to be payable otherwise than at sight or on demand.[206] Drafts drawn at sight or on demand with a notation thereon to "hold for arrival of goods," or payable "on arrival of car," or words of like effect, are taxable as drafts drawn otherwise than at sight or on demand. Any notation appearing on such drafts, or on a bill of lading or other papers accompanying same, including collection letter, which defers the time of payment, renders the draft taxable.[207] But a sight draft accompanied by instructions outside the instrument, as "Do not present until arrival of car" or some such memorandum, is not taxable.[208] And a sight draft accepted and paid by the collecting bank for the drawee, which holds it and charges interest until the drawee takes it up, is not taxable.[209] A draft might be drawn stating no time for payment, which would class it as a sight draft, and be accepted at ninety days, which would change its nature. If negotiated or delivered before acceptance the holder would be obliged to stamp it on acceptance, in default of which both he and the acceptor would be liable for the statutory penalty.[210] For the purposes of the tax there is no difference in the treatment of ordinary bills of exchange, trade acceptances, and bankers' acceptances, as defined by the regulations of the Federal Reserve Board.[211] The general rule is that a taxable draft or check becomes

206 T. D. 2682.

207 Letter from the Treasury Department dated February 20, 1918; W. T. S. 1918, ¶ 3686; T. D. 2682.

208 T. D. 2682.

209 T. D. 2682.

210 T. D. 2682.

211 T. D. 2682.

subject to tax concurrently with its delivery. In the case of a draft the rule means that the tax attaches, not when it is signed by the drawer, or presented to the drawee for acceptance, or accepted by him, but when it is delivered to the payee, if drawn to a third person, or negotiated by the drawer, if drawn to his order, whether such delivery or negotiation takes place before or after acceptance. If a draft was drawn and accepted before the passage of the Act, but not delivered or negotiated until afterward, the tax is payable.[212] The stamp tax attaches to all drafts covering articles shipped from a State of the United States, to the territory of Alaska, the territory of Hawaii and the Canal Zone; and although all drafts covering shipments to the Virgin Islands, the Philippine Islands and Porto Rico are not subject to the tax, all drafts covering articles shipped to the United States from the Virgin Islands or the Philippine Islands or Porto Rico must be stamped upon coming into the United States.[213]

DRAFTS DRAWN AGAINST EXPORTS. In view of the constitutional prohibition against a restriction of, or any tax on, exports, drafts with bills of lading attached covering goods in the course of exportation or drafts drawn in this country directly covering exports to foreign countries and which constitute an inherent, *bona fide* and necessary part of the process of exportation are exempt from the stamp tax.[214]

DRAFTS DELIVERED IN FOREIGN COUNTRIES. The general rule is that a taxable draft or check becomes subject to the tax if delivered within the territorial jurisdiction of the United States. The rule means that the tax does not attach to a draft drawn and accepted here, but delivered

212 T. D. 2682.

213 T. D. 2782.

214 T. D. 2682; Letter from Treasury Department dated April 13, 1918, W. T. S. 1918, ¶ 3707. Letter from Treasury Department dated January 24, 1918, W. T. S. 1918, ¶ 3683. See U. S. v. Hvoslef, 237 U. S. 1. Compare with Simpson v. Treat, 126 Fed. 1003. See paragraph on the Constitutionality of Stamp Taxes.

abroad, whether before or after acceptance, but does attach to a draft delivered here, whether before or after acceptance, although drawn and accepted abroad. In general, a draft sent through the mail is delivered when and where deposited in the mail addressed to the payee or the indorsee from the drawer. If a draft drawn abroad, on a foreign drawee, with a foreign payee, passes through a bank here in the course of collection, no tax is payable, unless it should be delivered by an agent of the drawer to an agent of the payee within the United States.[215]

NOTES DRAWN IN FOREIGN COUNTRIES. A promissory note drawn in a foreign country, and placed in the mails in that country for delivery to a person residing in the United States, is not required to be stamped. Delivery of commercial paper is necessary for its completion and by the weight of authority such an instrument is delivered when placed in the mails. The laws of the foreign country, therefore, would determine the validity of the contract, even if the instrument is made payable in the United States. On the other hand, a promissory note drawn in the United States and placed in the mails for delivery to a person residing in a foreign country is taxable, for the reason above stated.[216]

NOTES SECURED BY PLEDGE OF UNITED STATES SECURITIES. No stamp tax is required or imposed upon a promissory note secured by the pledge of bonds or obligations of the United States issued after April 24, 1917, or secured by the pledge of a promissory note which itself is secured by the pledge of such bonds or obligations, provided, that in either case the par value of such bonds or obligations does not exceed the amount of such note.[217] The bonds

215 T. D. 2682.

216 T. D. 2170. See also T. D. 2682.

217 Revenue Act of 1918, § 1107, Schedule A-6. This provision is now expressly included in the Stamp Tax Act, its substance having formerly been contained in T. D. 2701,.based upon the War Finance Corporation Act, Title 3, § 301.

mentioned include Liberty Bonds as well as other United States bonds and printed obligations.[218]

NOTES ISSUED BY GOVERNMENTS. The law provides that no bond, note or other instrument issued by the United States or by any foreign government or by any state, territory, or the District of Columbia or local subdivision thereof, or municipal or other corporation exercising the taxing power, shall be subject to tax.[219] Bank notes issued for circulation are also expressly exempted from the tax.[220]

Proxies. The tax is imposed on every proxy for voting at any election of officers or for voting at any meeting for the transaction of business of any corporation. The term "corporation" is defined to include associations, joint-stock companies and insurance companies. Under the 1914 law the tax was only on proxies for voting at any election of officers. The present law, as well as the 1917 Law, taxes all proxies used at meetings for the transaction of business. The tax is 10 cents on each proxy. Proxies for voting at any election of officers, or meeting for the transaction of business of any religious, educational, charitable, fraternal, or literary societies, or public cemeteries, are expressly exempt.[221]

PROXIES SIGNED BY TWO OR MORE STOCKHOLDERS. A 10 cent stamp is required for each signature upon a proxy where two or more stockholders or members have signed the same instrument.[222] A power of substitution contained in a proxy would seem not to be taxable either on the ground that it is a proxy or on the ground that it is a power of attorney.

WHEN STAMPED. It seems that the proxy need not be stamped until it is accepted by the person to whom it is issued, but must be stamped before it can be used. Thus,

218 T. D. 2701. War Finance Corporation Act, Title 3, § 301; Revenue Act of 1918, § 1107, Schedule A-6.

219 Revenue Act of 1918, § 1101.

220 Revenue Act of 1918, § 1107, Schedule A-6.

221 Revenue Act of 1918, § 1107, Schedule A-11.

222 T. D. 2129.

it has been held that a power of attorney or proxy executed by a person residing in a foreign country to a person residing in this country is taxable, as the instrument is not operative and effective until accepted by the person in this country to whom it is issued. Powers of attorney and proxies executed by a person residing in the United States to a person in a foreign country are not taxable.[223] Powers of attorney or proxies executed and accepted before the incidence of the tax are not taxable, even though used after the incidence of the tax.[224]

WHO MAY AFFIX STAMPS. Where proxies are sent out by corporations to be executed and returned to the corporation or to the person named in the proxy, such proxies may be stamped after execution and delivered by the person receiving the same as the agent of the person executing the proxy.[225] The stamp may be affixed and cancelled either by the party who executes the proxy or by the party to whom the proxy is given.[226] Where the stamp is affixed by an officer or employee of the corporation it is sufficient to cancel the stamp by writing thereon the initials of the officer or employee or the initials of the corporation and by incision or perforation if the stamp has a value of 10 cents or more.[227]

Rights to Receive Stock Dividends. Such rights are taxable as certificates of profits. See Capital Stock, Sales and Transfers above.

Rights to Subscribe for Stock. Under the present law, rights to subscribe for stock or to receive shares or certificates of stock (or of profits or interest in property or accumulations) in any corporation are expressly made subject to tax.[228] See Capital Stock, Sales and Transfers, above.

[223] T. D. 2129.
[224] T. D. 2129.
[225] T. D. 2067.
[226] T. D. 2129.
[227] Letter from Treasury Department dated January 8, 1915.
[228] Revenue Act of 1918, § 1107, Schedule A-4. See note 76.

Security Agreements and Applications for Loans. Neither a security agreement signed by a prospective borrower of a bank, empowering the bank to apply any securities, money, or other property of the prospective borrower in the hands of the bank to satisfy the debt of the borrower to the bank, nor the form of application for the loan, is included in the classes of instruments made subject to stamp tax under Schedule A of Section 1107, and neither is therefore subject to such tax.[229]

Shares Without Par Value. Under the 1914 Law, shares without par value were not subject to tax either on issue or transfer but under the present law as well as the 1917 Law, such shares are taxable. See Capital Stock, Issue and Capital Stock, Sales and Transfers, above.

Stock Certificates. See Capital Stock, Issue and Capital Stock, Sales and Transfers, above.

Transfers of Stock. See Capital Stock, Issue and Capital Stock, Sales and Transfers, above.

Voting Trust Certificates. It has been held that: (1) the transfer of stock from stockholders to voting trustee is subject to tax, (2) the receipt of the certificates given by the voting trustees to the stockholders is not subject to tax, (3) any sale or transfer of such voting trust certificates by the owner is subject to tax, (4) the transfer by the voting trustees to the stockholders at the termination of the voting trust agreement is subject to tax.[230] See Capital Stock, Sales and Transfers, above.

Records Required in Case of Sales and Transfers of Stock. In the following paragraphs certain regulations issued under the former law for the enforcement of the tax provided in subdivision 4 of Schedule A of such law are summarized. Since this subdivision, as contained in the 1918 Law, does not differ materially from the correspond-

229 See T. D. 2599.

230 Reg. No. 40, Part 1, Art. 1; Letter from Treasury Department dated May 22, 1918; W. T. S. 1918, ¶ 3722. See letter from Treasury Department dated January 7, 1915, for rulings as to voting trust certificates under the 1914 Law.

ing subdivision of the former law, except that sales and transfers of certificates of profits have been made taxable, these regulations will remain in force until they are repealed or superseded. The section number 1107 is substituted for 807 in the following paragraphs, and other references are changed to conform to the new law. It should be noted throughout that the terms "shares," "certificates" or "stock" include certificates of profits or of interest in property or accumulations under the 1918 Law.

Registration of Stock Brokers and Clearing Houses. Every person, partnership, corporation, exchange, or clearing house engaged in whole or in part in negotiating, making, or recording sales, agreements to sell, deliveries or transfers of shares or certificates, or in conducting or transacting a stock-brokerage business, or in the clearing, settling, or adjusting of any of the transactions referred to in section 1107, subdivision 4 of the 1918 Law, or who shall be engaged in the business of accepting or procuring the transmission of orders for the sale or purchase or transfers of stock to be made or executed at or under the rules or customs of an exchange in the continental United States, is required to file in the office of the collector of the district in which each place of business of such person, partnership, corporation, exchange or clearing house is located within ten days after engaging in business, and on the first day of July annually thereafter—a statement, under oath, setting forth: (a) in the case of a person or partnership, (1) the full name or names of such person or persons, and of all the members of such partnership conducting or transacting the business, (2) the post-office address or addresses of such person or persons, or partnership; and (b) in the case of a corporation, exchange, or clearing house, (1) its principal office or place of business, (2) the names and addresses of its chief officer and secretary, (3) a list of its members and their addresses, (4) if incorporated, when and where incorporated, and (5) if unincorporated under what agreement or authority it is conducting such business or agency. Such statement must also, in both the above

cases, (1) specifically set forth the character of the business to be conducted, (2) contain information as to whether the person executing the same has been licensed under any State laws or under any other provision of Federal law; and if so, the dates and places at which any such licenses were issued, (3) be executed and duly acknowledged by the person or persons so conducting or intending to conduct said business, or by the president or secretary of the corporation or exchange or clearing house. Each exchange or clearing house is required also to file with the collector a copy of its constitution, charter, agreement of association, by-laws, rules and regulations, and of all amendments thereto, as they may be adopted, and the names and addresses of new members as they are admitted to membership. Such statements should be made upon forms to be furnished upon application to the collector.[231]

Certificate of Registry. Every collector is required to file and preserve each such statement of registration and issue to such person, partnership, exchange, clearing house, or corporation a certificate of registry, showing: (a) the date of issue, (b) the name of the person or persons, or exchange, clearing house, or corporation, conducting the business, (c) the nature of the business for which the license is granted, and (d) the date of expiration of said registry. This certificate must be signed by the collector and posted in some prominent place in the office of the person, partnership, exchange, clearing house, or corporation during the period for which issued. If such business is conducted at more than one place, a certificate must be posted in each place of business.[232]

Record of Sales or Transfers of Stock. All persons wholly or partly engaged in the business of buying, selling, or transferring shares of stock, whether at public or private sale, or whether or not they are members of an exchange, including persons engaged in transactions known as

231 Reg. No. 40, Part 1, Art. 2. See Form No. 741.
232 Reg. No. 40, Part 1, Art. 3.

"matched," or "on-order," or "pass-outs," or by any other name or term at, on or in any exchange or similar place, whether or not such transactions are cleared, adjusted, or settled through a clearing house or directly between seller and buyer, or otherwise, are required to keep a record showing—

(a) The date of the transaction.

(b) The name of the seller or transferor.

(c) The name of the purchaser or transferee.

(d) If the order was executed on an exchange, the name of the person who executed the order.

(e) Whether the transaction is a purchase or sale.

(f) The name of the corporation the stock of which is the subject of the sale, and the number of shares thereof.

(g) Whether the stock was listed on an exchange.

(h) Whether the stock was cleared through a clearing house.

(i) The face or par value of the stock.

(j) The price of the stock, if there is no face or par value.

(k) Whether the shares were borrowed or loaned.

(l) Whether the transaction was "matched," "on order," a "pass-out," or a "scratched sale," or any other kind of sale or purchase.

(m) The amount of tax paid.

(n) The identifying number of the bill or memorandum of sale.

(o) The origin of the order, whether domestic (referring to the continental United States), or foreign (referring to other countries).

Persons using forms may incorporate therein additional columns of use to them, such columns to be placed after the columns containing the above information, so as not to interfere with the columns and headings prescribed. These records must be in book form, and all entries must be legibly written in ink and the records kept for two

years. Such record forms will not be supplied by the Treasury Department.[233]

RETURNS OF PERSONS MAKING SALES OF STOCK. All persons wholly or partly engaged in the business of buying, selling, or transferring shares of stock at, in, or on an exchange, whether or not such sales, purchases, or transfers are made, cleared, settled, or adjusted through a clearing house must, on or before the fifteenth day of each month, and at any other time or times designated by the Commissioner, render, under oath, a true return of all such sales and purchases for the preceding month or for any other designated period, containing the following information:

(a) The month for which the return is made.

(b) The name and address of the person, partnership, corporation, or association making the return.

(c) The number of shares of stock sold and purchased on such exchange and cleared by its clearing agency or association.

(d) The number of shares of stock sold and purchased on such exchange that were not cleared by its clearing agency or association.

(e) In respect of shares having a face (or par) value:

(1) The aggregate face value of all shares, not including any fraction of less than $100 of face value involved in any transaction.

(2) The number of fractions of less than $100 of face value involved in all transactions.

(f) In respect of shares having no face (or par) value:

(1) As to such shares of an actual value in excess of $100 per share.

A. The aggregate actual value of all shares, not including any fraction of less than $100 involved in any transaction.

B. The number of fractions of less than $100 involved in all transactions in such shares.

[233] Reg. No. 40, Part 1, Art. 8. The regulation sets forth in full the form of record required for clearing house transactions and ex-clearing house transactions. Books containing such forms are now supplied by the leading stationers in the large cities.

(2) As to such shares of an actual value of $100 or less per share—

A. The total number of such shares.

(g) As to shares purchased, the same information and detail required for shares sold, transferred, and delivered required under (e) and (f) for shares sold, transferred, or delivered.

(h) The number of shares of stock borrowed.

(i) The number of shares of stock loaned.

(j) The number of shares of loaned stock returned.

(k) The number of shares of borrowed stock returned.

(l) The amount of tax paid.

(m) The amount, in dollars, of stamps purchased during the month.

(n) The amount, in dollars, of stamps on hand on the last day of the month for which return is being made.

Such returns must be made upon forms furnished upon application by the internal revenue collector.

The Commissioner may, from time to time, require any person wholly or partly engaged in the business of buying, selling, or transferring shares of stock, whether at public or private sale, and whether or not such sale shall be made on an exchange or cleared, settled, or adjusted through a clearing house, to render under oath returns of all such transactions upon forms prescribed by him.[234]

RETURNS BY CLEARING HOUSES. Every clearing house or committee or body through or by which clearing is done must, on or before the fifteenth day of each month, and at any other time designated by the Commissioner, render under oath a return for the preceding month, or for any other period that may be designated, of all facts in their possession relating to any and all such transactions, and showing in detail:

(a) The month for which return is made;

(b) The name and address of the clearing house or

234 Reg. No. 40, Part 1, Art. 9.

similar business, agency, or institution making the return; and

(c) The number of shares of stock directed to be received and the number of shares of stock directed to be delivered and cleared, settled, or adjusted for each member during the month or period for which the return is made.

Such return shall be made upon the forms to be furnished upon application by the collector.

If any person negotiating sales or transfers of stock on a stock exchange, (a) appoints in writing the clearing house for such exchange upon which such sale or transfers are made, his agent for the purposes hereinafter indicated such clearing house being approved by the Commissioner and (b) shall make a return, statement or sheet to such clearing house, containing a full disclosure on each business day (1) of all such transactions (both such as are clearable and non-clearable) of the preceding day in shares of stock listed or permitted to be dealt in by such member on such exchange, (2) which, if any, of such stocks are loaned or borrowed, then such return, statement, or sheet will be deemed to be the bill, or memorandum of sale, or agreement to sell, required under section 1107, subdivision 4, of the 1918 Law and the clearing house is authorized to affix to such return, statement or sheet the amount of stamps required for each sale or agreement to sell or memorandum of sale for delivery or transfer of such stock indicated thereon, and to cancel the stamps so affixed. The affixing and cancellation of such stamps by the clearing house is held to be that of the person making such sale or agreement to sell, or memorandum of sale, for delivery or transfer of such stock. The returns, statements, or sheets made to the clearing house must, in respect of each sale, show: (a) the date thereof, (b) the name of the seller, (c) the name of the buyer, (d) the amount of the sale, and (e) the name of the stock, certificates, voting shares, or other things traded in. A return for more than one sale may be upon the same return, statement, or sheet, and no settlement of differences or other dealings between mem-

bers that will interfere with the full disclosure of the whole transaction is permitted.

The clearing house must preserve such returns, statements, or sheets for at least two years.

Such return, statement, or sheet to the clearing house will not relieve the person from making the required monthly return.

Wherever any clearing house association or similar body carries upon its sheets or records information or reports of transactions showing the transfer by one of its members of an account of a customer without change of ownership of the securities of the customer, the members of such clearing house or body concerned in such transaction are required to keep a record showing the particulars of such transactions.[235]

SUBSTITUTE RETURNS—AGENTS. If any person or clearing house fails or refuses to make such return within the time prescribed, it may be made by an internal revenue officer, upon inspection of the books and papers of such person or clearing house; but such making of a return by an internal revenue officer does not relieve the person or clearing house in default from any penalty incurred by reason of the failure.

Any officer designated by the Commissioner has authority to examine the books, papers, and records kept in accordance with the above stated rules and may require the production of any other books, records, papers, or statements of account, necessary to determine any liability to the tax or to the observance of the provisions of the regulations.[236]

Sale of Stamps. No person other than a Collector, or duly authorized deputy collector, Assistant Treasurer, or United States designated depositary shall sell or expose for sale, give away, traffic in, trade, barter, lend, borrow, or exchange any stamps, issued pursuant to these regulations: provided, That any person or corporation which has been

[235] Reg. No. 40. Part 1, Art. 10.
[236] Reg. No. 40. Part 1, Art. 11.

fully appointed and constituted and is acting agent of any State for the sale of stock transfer stamps of such State, may upon giving bond in a sum to be fixed by the Commissioner, sell United States stamps issued pursuant to these regulations when approved and authorized by the Commissioner. No person shall buy, receive, or have in his possession or under his control, any stamps issued pursuant to these regulations, unless such stamps have been purchased directly from the Collector, or duly authorized Deputy Collector, Assistant Treasurer, United States designated depositary, or a designated agent for the sale of State stock transfer stamps when authorized by the Commissioner, in the district in which the stamps are to be used.

All requisitions for stamps to be used under these regulations shall be made in writing on a form prescribed by the Commissioner to the Collector, or duly authorized Deputy Collector, Assistant Treasurer or United States designated depositary or State agent authorized by the Commissioner, in the Internal Revenue district in which the stamps are to be used, giving the date thereof, the number and denomination of stamps applied for and the name and address of the purchaser, and shall be signed in ink by the person receiving such stamps. If the requisition for such stamps shall be made to any Assistant Treasurer or United States designated depositary or duly authorized State agent for sale of State Stock transfer stamps, such Assistant Treasurer or United States designated depositary or duly authorized State agent shall keep a record thereof, and at the end of each month shall file with the Collector of the district a statement setting forth the number, denomination, and amount of all stamps on hand at the beginning of each month, the number, denomination and amount sold during the month, and the number, denomination, and amount on hand at the end of the month, accompanied by the requisitions filed by each purchaser, and on or before the fifteenth day of each month shall pay over to such Collector all money received from sales of such stamps for the preceding month

and take his receipt therefor. The Collector shall keep the requisitions for stamps sold by him and those sold by such Assistant Treasurer, United States designated depositary or authorized State agent separate and apart from all other requisitions for stamps and shall preserve them in his office for a period of two years. The stamps to be used under these regulations shall be of such kind and color as the Commissioner shall prescribe.[237]

Records Required in Case of Sales of Produce on Exchange. In the following paragraphs certain regulations issued under the former law for the enforcement of the tax provided in subdivision 5 of Schedule A of such law are summarized. Since this subdivision, as contained in the 1918 Law, does not differ materially from the corresponding subdivision of the former law, except that so-called transferred or scratch sales are no longer taxable, these regulations will remain in force until repealed or superseded. A few references are changed to conform to the new law, and it should be noted throughout that so-called transferred or scratch sales are no longer taxable.

REGISTRATION OF DEALERS IN FUTURES. Every person engaged in whole or in part in making contracts of sale of any product or merchandise or commodity at, on, or in, or under the rules or usages of any exchange for future delivery, or engaged in the business of accepting or producing the transmission of such contracts of sale, to be executed on any exchange, and every exchange and every clearing house, is required to file in the office of the collector of the district in which each place of business of such person, exchange, or clearing house is located within ten days after engaging in business, and on the first day of July annually thereafter a statement, under oath, setting forth: (a) in the case of a person, (1) the full name of such person, and (2) his post-office address; (b) in the case of a partnership, (1) the full names of all the members thereof, and (2)

[237] Reg. No. 40, Part 1, Art. 12, as promulgated in T. D. 2741, effective June 25, 1918. These stamps are ordered on Form No. 743.

the post-office address of the partnership; and (c) in the case of a corporation or association (1) its principal office or place of business, (2) the names and addresses of its chief officer and its secretary, (3) a list of its members and their addresses, (4) if incorporated, when and where incorporated, and (5) if unincorporated, under what agreement or authority it is conducting business, together with a copy of such agreement. Every statement filed by an exchange or clearing house must also specifically set forth the character of the business conducted or intended to be conducted and each exchange and clearing house is required also to file with the collector a copy of its constitution, charter, agreement of association, by-laws, and regulations, and all amendments thereto, as they may be adopted, and the names and addresses of new members as they are admitted to membership. Statements filed in behalf of any corporation, association, exchange, or clearing house should be executed and duly acknowledged by the president or secretary thereof.

The statements required by these regulations should be made upon forms to be prescribed by the Commissioner.[238]

Records and Certificates. Every collector is required to file and preserve each such statement of registration, and shall issue to the person making such statement a certificate of registry showing: (a) the date of issue, (b) the name of the person, (c) the nature of the business for which the certificate is granted, and (d) the date of the expiration of the registration. This certificate must be signed by the collector and posted in some prominent place in the office of the person receiving it at all times during the period for which it is issued. If the business of such person is conducted at more than one place, a certificate must be so posted in each place of business.[239]

Records by Sellers and Buyers. All persons making sales or contracts of sale, except so-called transferred or

[238] Reg. No. 40, Part 2. Art. 2.
[239] Reg. No. 40. Part 2, Art. 3.

scratch sales, of any product or merchandise at, on, in, or under the rules or usages of any exchange, for future delivery, are required to keep a record showing:

(a) The date when the contract was made.

(b) The name and address of the other party to the contract.

(c) The name of the person executing the contract.

(d) Whether the transaction is a purchase or sale.

(e) The quantity of product, merchandise, or commodity involved; whether in tons, pounds, bales, bushels, bags, mats, barrels, gallons, or other unit of measure or weight, as the case may be.

(f) The name of the product, merchandise, or commodity, including (if not a basis grade contract) the grade, type sample, or description.

(g) The name of the customer.

(h) Whether the contract is a "basis grade" contract.

(i) The time specified in the contract for delivery.

(j) The specified price per ton, pound, mat, bale, bag, bushel, barrel, gallon, or other unit of measure of weight, as the case may be.

(k) The gross amount of sale or purchase.

(l) The amount of tax paid.

(m) Whether the order for sale or purchase was of domestic (meaning the continental United States) or foreign (meaning from countries other than the continental United States) origin.

(n) The date of delivery or settlement.

(o) The method of fulfillment or settlement.

Persons who use forms may incorporate additional columns of use to them such columns to be placed in such positions as not to interfere with the columns and headings prescribed. Such record forms will not be supplied by the Treasury Department.[240]

[240] The regulation sets forth in full the form of record required. Books containing such forms are now being supplied by the leading stationers in the large cities.

These records must be legibly written in ink and kept separate in books, and contracts of sale for future delivery of two or more distinct products or merchandise shall be kept separate. Any person executing or making such contracts of sale must preserve the trading cards, memoranda, or slips of each transaction, and the purchaser must preserve the bill, memorandum, or evidence of sale to which the stamps are affixed, for two years.[241]

Records to be Kept by Clearing Houses. All persons acting in the capacity of a clearing house or clearing association are required to keep a record showing:

(a) The name of the person for whom each contract is cleared.

(b) The date when the contract was made.

(c) Whether the transaction is a purchase or sale.

(d) The quantity of product, merchandise, or commodity involved, whether in tons, pounds, bales, bushels, bags, mats, barrels, gallons, or other unit of measure or weight, as the case may be.

(e) The name of the product, merchandise, or commodity, including (if not a basis-grade contract) grade, type, sample, or description.

(f) Whether the contract is a basis grade contract.

(g) The time specified in the contract for delivery.

(h) The date of settlement.

(i) The method of settlement.

Records of sales for future delivery of two or more distinct products or merchandise must be kept separate.[242]

Returns by Members of Exchanges. All persons making contracts of sale of any commodity, product, or merchandise, at, on, or in any exchange, board of trade or other similar place of business for future delivery, whether such contracts are cleared and adjusted through a clearing house, or clearing association, or directly between the seller and buyer, or otherwise, must on or before the fifteenth day of each month, and at any other time required

[241] Reg. No. 40, Part 2, Art. 6.
[242] Reg. No. 40, Part 2, Art. 7.

by the Commissioner, make a verified return for the preceding month or any other period, showing:

(a) The number of contracts of sale and purchase of each product, merchandise, or commodity brought forward from the preceding month.

(b) The number of contracts of sale and purchase of each product, merchandise, or commodity during the current month.

(c) The month in which the products, merchandise, or commodity is to be delivered.

(d) The method of settlement of each contract, i. e., whether by "actual delivery," "notice," "ring," "direct," "transfer," "pair off," or "matched," "pass out," "set-off," "give up," through a clearing house or clearing association, or otherwise.

(e) The gross amount of the contracts of sale.

(f) The tax paid thereon.

(g) The number of contracts both of purchase and sale left open at the end of the month.

(h) The amount of stamps on hand from the preceding month.

(i) The amount of stamps purchased during the month.

(j) The amount of stamps used during the month.

(k) The balance of stamps on hand at end of the month.

(l) The origin of the order of the contracts, whether domestic or foreign.

Such returns should be made upon forms to be furnished upon application, by the collector of the district in which the exchange, board of trade, or other similar place, is located.[243]

Returns by Clearing Houses. Every clearing house, or clearing association, must, on or before the fifteenth day of each month and at any other time required, render under oath a return, for the preceding month or for any other period designated, of all facts in their possession showing:

[243] Reg. No. 40, Part 2, Art. 8.

(a) The number of contracts "long" or "short" for each member brought forward from the preceding month.

(b) The number of contracts bought or sold by each member of the association.

(c) The number of tons, pounds, bales, bushels, bags, mats, barrels, or gallons or other units of weight or measure involved in such contracts as the case may be.

(d) The month in which such product, merchandise, or commodity is to be delivered.

(e) The method of settlement of said contracts—i. e., whether by "set-off," "notice," or "delivery," or by any other method.

(f) The number of open contracts "long" and "short" for each member carried to the following month.

Such returns should be made upon forms to be furnished, upon application, by the collector of the district in which the clearing house or clearing association is situated.[244]

FAILURE TO MAKE RETURNS. If any person, or clearing house, or clearing association, fails or refuses to make such return within the time prescribed, the same rules obtain as in the case of a similar failure or refusal by a person or clearing house under the regulations relating to sales and transfers of stock.[245] See Records Required in Case of Sales and Transfers of Stock, Substitute Returns—Agents, above.

Sale of Stamps. The regulations governing the sale of stamps to be used for the payment of taxes upon sales or contracts of sale of any product or merchandise for future delivery is identical in phraseology with the regulation given at length under a previous paragraph, and need not be repeated here.[246]

244 Reg. No. 40, Part 2, Art. 9.

245 Reg. No. 40, Part 2, Art. 10.

246 See page 857. Reg. No. 40, Part 2, Art. 11 was formerly somewhat different in its terms from Reg. No. 40, Part 1, Art. 12. These regulations are made identical in their terms by their promulgation in T. D. 2741 effective June 25, 1918. Reg. No. 40, Part 1, Art. 12

Penalties. Several penalties are provided in Title XI of the Revenue Act of 1918, which are dealt with in the following paragraphs.

Issuing or Accepting Unstamped Instruments. Anyone who makes, signs, issues or accepts an instrument without the full amount of the tax being paid thereon is guilty of a misdemeanor punishable by a fine of not more than $100 for each offense.[247]

Consigning or Shipping Articles Without Paying Tax. Anyone who consigns or ships an article by parcel post without the full amount of tax being paid thereon is guilty of a misdemeanor punishable by a fine of not more than $100 for each offense.[248]

Selling Playing Cards Without Paying the Tax. Anyone who manufactures and imports or sells any playing cards, package or other article without the full amount of tax being paid thereon is guilty of a misdemeanor punishable by a fine of not more than $100 for each offense.[249]

Failure to Cancel Stamps. Anyone who makes use of a stamp without cancelling or obliterating the same is guilty of a misdemeanor punishable by a fine of not more than $100 for each offense.[250]

Fraudulent Removal or Reuse of Stamps. The penalty for fraudulent removal or reuse of a stamp or having possession of washed, restored or altered stamps removed from any instrument is a fine of not more than $1,000 or imprisonment for not more than five years or both, and the reused, cancelled or counterfeit stamp together with

refers to Stock Transfer Stamps, and Reg. No. 40, Part 2, Art. 11 to Future Delivery Stamps. Future Delivery Stamps are ordered on Form No. 744.

247 Revenue Act of 1918, § 1102. The word "accept" is used in this section in the general sense of "receive," not in the special sense peculiar to drafts. (T. D. 2682.)

248 Revenue Act of 1918, § 1102.

249 Revenue Act of 1918, § 1102.

250 Revenue Act of 1918, § 1102.

the document, package or article upon which it is placed or impressed may be forfeited to the United States.[251]

Transferring Stock Without Paying Tax. Any person liable to pay the tax on sales or transfers of capital stock or certificates of profits or any one acting as agent or broker for such person, who makes any sale, or in pursuance of a sale delivers any certificate or evidence of the sale of any stock, interest or right or bill or memorandum thereof, without the proper stamps affixed thereto with intent to evade the law is guilty of a misdemeanor punishable by a fine of not more than $1,000, or by imprisonment for not more than six months, or both.[252]

Making Sales of Produce Without Paying Tax. Any person liable to pay the tax on sales of produce on any exchange or anyone acting as agent or broker for such person, who makes any sale, or agreement of sale or agreement to sell, or pursuant thereto, delivers any products or merchandise without a bill, memorandum or other evidence thereof, or who delivers such bill, memorandum or evidence, without having the proper stamps affixed thereto, is guilty of a misdemeanor punishable by a fine of not more than $1,000, or by imprisonment for not more than six months, or both.[253]

Failure to Stamp Insurance Policies. Any person to or for whom or in whose name any insurance policy, taxable under Title XI is issued, or any solicitor or broker acting for or in behalf of such person in the procurement of any such policy, for failure to affix the proper stamps with intent to evade the tax, in addition to other penalties provided herefor, will be obliged to pay a fine of double the amount of the tax.[254]

Other Penalties. The present law contains no provision that an unstamped instrument shall be void or shall not be admitted as evidence in the courts or shall not be

[251] Revenue Act of 1918, § 1103.
[252] Revenue Act of 1918, § 1107, Schedule A-4.
[253] Revenue Act of 1918. § 1107, Schedule A-5.
[254] Revenue Act of 1918, § 1107, Schedule A-15.

placed on record. But Sections 13, 14 and 15 of the Act of June 13, 1898, as amended by the Act of March 2, 1901, are held by the Treasury Department to be still in force, and to apply to deeds to the extent that they forbid the record and admission in evidence of unstamped deeds and require their presentation to the collector of the district for validation.[255] Section 13 makes provision for the stamping of documents issued without stamps; Section 14 that unstamped instruments are not admissible in evidence; and Section 15 that unstamped instruments shall not be recorded.[256] The provisions of these sections for refusing record and admission in evidence to unstamped deeds and their validation by collectors being still effective, to obviate any questions which might arise as to the validity of unstamped deeds, the proper course is to follow the procedure fixed therein.[257]

EXCLUDING UNSTAMPED DOCUMENTS IN STATE COURTS. There is some conflict of authority on the question whether the federal government has any authority under the constitution to prescribe rules of evidence for the state courts, and to preclude the acceptance in evidence of unstamped or improperly stamped instruments in the state courts. There are cases holding expressly that the federal government has such power, or holding to the same effect by excluding unstamped or improperly stamped documents,[258] but the weight of authority and the best considered cases seem to establish a contrary rule.[259] One of

255 Letter from Treasury Department dated May 27, 1918; W. T. S. 1918, ¶ 3723. Sections 2, 4, 6, 12, 18, 20, 21, 22, 23, 24, 25, Schedule A, Schedule B, Sections 27, 28, 29 and 50, of the Act of June 13, 1898, were expressly repealed by the Act of April 12, 1902. (32 Stat. 96.)

256 The sections are printed in full at the end of this book.

257 Letter from Treasury Department dated May 27, 1918; W. T. S. 1918, ¶ 3723.

258 Chartiers etc. Co. v. McNamara, 72 Pa. St. 278; Hoops v. Dunham, 41 Ga. 109.

259 Peo. ex rel. Barbour v. Gates, 43 N. Y. 40; Moore v. Moore, 47 N. Y. 467; Rowe v. Bowman, 183 Mass. 488, 67 N. E. 636; Davis v. Evans, 133 N. C. 320, 45 S. E. 643; Cassidy v. St. Germain, 22 R. I.

the best statements on the subject, contained in a Georgia case[260] which arose under the 1898 Law, of which the above sections 13, 14 and 15 once formed a part, reads as follows: "We fully recognize the power of Congress to levy and collect taxes for the support of the government. We fully recognize its power to do this by the imposition of stamp duties, and to prescribe penalties for their non-payment. We also recognize its power to regulate the practice and procedure and to provide rules of evidence in courts established under the constitution of the United States. After much reflection and a careful and thorough investigation of cases in the courts of other States, we have come to the conclusion, however, that Congress has no power to prescribe rules of evidence for a State court. Under our system of government, the States retained all powers of sovereignty which were not graned to the general government by the constitution. They had the power to create and establish their own courts, and to regulate the practice and procedure, and to prescribe rules of evidence therein. There is nothing in the constitution of the United States which expressly or by implication gives to Congress the power to prescribe rules of evidence for the courts of the States. Of course Congress, having the power to impose stamp duties, has the power to provide for the enforcement of their payment by any necessary and proper means. But while to make unstamped instruments inadmissible in evidence in State courts would doubtless aid in compelling the payment of the tax, we think that such a method of collection is nei-

53, 46 Atl. 350; Garland v. Gaines, 73 Conn. 662, 49 Atl. 19; Clemens v. Conrad, 19 Mich. 170; Sammons v. Halloway, 21 Mich. 162; Craig v. Dimock, 47 Ill. 308; Duffy v. Hobson, 40 Cal. 240; Pargoud v. Richardson, 30 La. Ann. 1286; Knox v. Rossi, 25 Nev. 96, 57 Pac. 179, 48 L. R. A. 305 (note). Many more cases could be cited to the same effect, but the above are leading cases, and it is believed that they will furnish a guide to a complete list of the authorities.

260 Small v. Slocumb, 112 Ga. 279; 37 S. E. 481. This case contains an exhaustive examination of the authorities, and expressly disapproves of Chartiers etc. Co. v. McNamara, 72 Pa. St. 278.

ther necessary nor proper, and is therefore not within the power of Congress. The act of 1898 subjects to a penalty any one who fails or refuses to comply with the provisions as to stamping written instruments, and the Federal courts have ample machinery for the enforcement of this penalty. No other method of enforcement would seem to be necessary, but, even if it were, Congress has power to provide that no unstamped instrument shall be received in evidence in any of the Federal courts. An attempt to extend this provision so as to make it applicable to the courts of the several States can not, therefore, be defended upon the ground that it is necessary. Nor do we think it a proper means of enforcing the stamp act to interfere with courts peculiarly within the control of the several States, by declaring what shall or shall not be used as evidence in them, or to seek to make the State courts punish a failure to comply with the Federal stamp act by refusing to allow unstamped documents to be used as evidence in them.'' These state decisions have no application to federal courts, where the laws of Congress, prescribing rules of evidence must be observed.[261] And it has been held that even though a deed improperly stamped is admissible in evidence in the State courts, a purchaser at a judicial sale is entitled to a deed which will defend his title in any tribunal where it is attacked or where he is called upon to assert it, and that a referee to sell must affix the required stamps to his deed to such purchaser.[262]

VOIDING INSTRUMENTS FOR FAILURE TO STAMP. It is held that a deed, note or other instrument is not rendered absolutely void by a failure to stamp it properly,[263] but it is also held that such deed, note, or other instrument, is rendered void if the omission to stamp the same is wil-

261 Sackett v. M'Caffrey, 131 Fed. 219.

262 Loring v. Chase, 26 Misc. 318; 56 N. Y. Supp. 312.

263 Moore v. Moore, 47 N. Y. 467; Goodwine v. Wands, 25 Ind. 101; Adams v. Dale, 29 Ind. 273; D'Armond v. Dubose, 22 La. Ann. 131.

ful or with intent to evade the tax.[264] The point is in some confusion and no general rule can be safely formulated.

Constitutionality of Stamp Taxes. The constitutionality of various stamp tax acts has only been attacked on certain grounds and in reference to particular clauses, and no general deduction can be made as to the constitutionality of the present statute *in toto.* In one of the leading cases on the subject[265] it was decided that the 1898 Law was valid, in so far as it placed a stamp tax upon sales, agreements of sale, or agreements to sell any products or merchandise at any exchange or board of trade, or other similar place, either for present or future delivery. The court held that the tax was not a direct tax, but a duty or excise tax laid upon the privilege or opportunity afforded by boards of trade or exchanges for the transaction of business, although the amount of the tax was measured by the value of the property sold; and that it was immaterial that the tax could not be added to the price of the thing sold. The tax was also held to be uniform both in the geographical sense and in the sense that it taxed all taxpayers similarly situated, since there was a reasonable basis of classification in taxing all sales on exchanges. The court ruled further that the tax was not invalid or discriminatory (a) because it applied only to sellers and not to purchasers; (b) because it did not tax the same privilege when used for all purposes, and (c) because it required a person selling property in intra-state commerce to make a memorandum, this being a proper means for the collection of the tax and a legislative question. The stamp tax on a memorandum or contract of sale of a certificate of stock imposed by the 1898 Law was held not

264 Dowell v. Applegate, 7 Fed. 881; Rowe v. Bowman, 183 Mass. 488, 67 N. E. 636; Cassidy v. St. Germain, 22 R. I. 53, 46 Atl. 350; Hooper v. Whitaker, 130 Ala. 324, 30 So. 355; Harvey v. Wieland, 115 Ia. 564, 88 N. W. 1077; Ohio R. Junc. R. R. Co. v. Penna. Co., 222 Pa. St. 573, 72 Atl. 271.

265 Nicol v. Ames, 173 U. S. 509.

to be a direct tax but to fall within the class of duties, imposts and excises permitted under the first clause of Section 8 of Article 1 of the Constitution.[266] It has been held that the statute[267] giving the Commissioner of Internal Revenue power to require persons, who fail or refuse to make proper returns for stamp tax as well as other tax purposes, to produce their books, is not unconstitutional, since an order to produce books is not violative of the rights of a witness, though such rights may be invaded after his appearance.[268] In a recent case[269] it was contended that the 1914 Law was unconstitutional and void if it imposed a tax of any kind upon the deed given by a referee in pursuance of the order and as a part of the procedure of a State Court. It was held that the Act was not invalid in this respect as imposing a tax on the state's exercise of its governmental functions, since the tax imposed was an excise tax on the business transaction involved in the purchase of the land from the referee and its transfer to the purchaser, and that the transfer was in its nature the same as any transfer from one individual to another. But the 1898 Law so far as it attempted to impose a tax on charter parties used exclusively for the carriage of cargo from ports in the United States to foreign ports, was held to be a direct, and not incidental, tax on exports or exportation and, therefore, in this respect unconstitutional.[270] It is probable that the present law would not be upheld if it were construed in any way to place a tax upon exports or exportation.[271] And

266 Thomas v. U. S., 192 U. S. 362. For a full discussion of the subject see the opinion of the lower court, 115 Fed. 207.

267 R. S. § 3173.

268 Calkins v. Smietanka, 240 Fed. 138.

269 Home Title Ins. Co. v. Keith, 230 Fed. 905. This case contains a lengthy discussion of the authorities holding in favor of the constitutionality of the statute.

270 U. S. v. Hvoslef, 237 U. S. 1. Compare with Simpson v. Treat, 126 Fed. 1003.

271 See T. D. 2682. Letter from Treasury Department dated April 13, 1918, W. T. S. 1918, ¶ 3707; letter from Treasury Department dated January 24, 1918, W. T. S. 1918, ¶ 3683.

it seems that any construction of Sections 13, 14 and 15 of the 1898 Law, which are held to be still in force,[272] whereby unstamped or improperly stamped deeds, notes or other instruments, were denied admission in evidence in State courts would render the section unconstitutional as an attempt on the part of the federal government to prescribe rules of evidence for the State courts.[273] Consequently such sections probably apply only to the federal courts, since it is a well known rule of statutory construction that where a statute admits of two constructions one of which presses it beyond constitutionality and the other of which brings it within constitutionality or avoids the question, the courts tend to adopt the latter interpretation.[274] An amendment to the stock transfer act of New York imposing a tax of 2 cents *"on each share* of one hundred dollars of face value or fraction thereof" instead of "on each one hundred dollars of face value or fraction thereof" as provided in the original law was held unconstitutional on the ground that such amendment taxed the sale of all shares of the face value of one hundred dollars and also all shares of the face value of any fraction of one hundred dollars, the words "fraction thereof" being held to relate to "share" rather than to "one hundred dollars"; and that therefore the tax was measured by the number of shares regardless of face value instead of the face value of the shares; that all corporate shares were placed in a class but all members of the class were not treated alike; that the statute bore heavily

[272] Letter from Treasury Department dated May 27, 1918; W. T. S. 1918, ¶ 3723.

[273] See paragraph on Excluding Unstamped Documents in State Courts.

[274] See paragraph Construction Which Will be Constitutional in the chapter on Construction of the Law. In Sackett v. M'Caffrey, 131 Fed. 219, the court declined to discuss the correctness of the state decisions adopting the interpretations of Sections 13, 14, and 15 of the Act of June 13, 1898, which restrict the prohibition against the admission of unstamped documents as evidence to the federal courts and thus saves the sections from unconstitutionality.

upon some and lightly upon others in the same situation without method or order or reason and resulted in arbitrary or accidental selection rather than classification. While wide latitude in classification is possessed by the legislature, this power is not without the limitation that any classification adopted must have some basis, reasonable or unreasonable, other than mere accident, whim or caprice and must not result in an arbitrary discrimination in favor of one as against another of the same class. So far as the tax on the issue and sales or transfers of certificates or shares without par or face value of which the actual value does not exceed $100 per certificate or share is concerned, the Revenue Act of 1918, like the above unconstitutional amendment imposes a tax without reference to the actual value of the certificates or shares issued or transferred and in many cases would seem to constitute arbitrary selection rather than constitutional classification.[275]

Injunctive Relief. The general rule that a taxpayer may not resort to a suit to restrain the assessment or collection of any tax applies to stamp taxes and a taxpayer is not entitled to an injunction to restrain the Commissioner of Internal Revenue from assessing the taxes on sales of grain to which no stamps have been affixed, the only remedy to the taxpayer in such case being by suit to recover the tax.[276]

Payment Under Protest and Duress. The general rule of law, that a voluntary payment of money cannot be recovered, applies to stamp taxes. A person, therefore, who wishes to recover the amount of any stamp tax, which he considers illegally exacted, should pay the tax under protest and such payment should be involuntary and under duress. Stamp taxes paid under protest or with notice that the payer contends that they are illegal and intends to institute suit to compel their repayment, may

[275] Peo. v. Mensching, 187 N. Y. 8.

[276] Calkins v. Smietanka, 240 Fed. 138. See R. S. §§ 3224, 3226.

on occasion be recovered, although generally speaking even a protest or notice will not avail if the payment be made voluntarily with full knowledge of the circumstances and without any coercion by the actual or threatened exercise of power possessed by the party exacting or receiving the payment over the person or property of the party making the payment from which the latter has no other means of immediate relief than such payment. The rule is firmly established that stamp taxes voluntarily paid cannot be recovered back and that payments with knowledge and without compulsion are voluntary. Thus, in a case[877] in which certain stamps were purchased from the collector who was not informed when the purchase was made of the particular purpose and who was given no intimation of any claim that the purchaser was acting under duress, recovery was denied even though the purchaser affixed the stamps in order to complete the transaction between himself and the vendee named in the deed to be stamped and to obtain the consideration for the property transferred. It was held that this transaction, while it might have constituted duress as between the parties to the deed, was a matter with which the collector had nothing to do and that the payment to the collector for the stamps was purely voluntary. The written application to the Commissioner to recover the amount paid for the stamps was held not to be the statutory equivalent of a common-law protest or notice of suit. While the Commissioner under The Revised Statutes[878] may have refunded the amount of such tax, an appeal was not permitted from his refusal to refund because it was not a ruling either specific or resulting from a demand, to which the taxpayer yielded under protest and with notice, and from which he appealed to the Commissioner of Internal Revenue. Likewise, where a stamp tax was paid on manifests of cargoes on certain vessels bound to foreign ports

[877] Chesbrough v. U. S., 192 U. S. 253.
[878] R. S. § 3220.

as required by the 1898 Law, no information having been given to the person from whom the stamps were bought of the particular purpose, or claim made to the collector or Commissioner that the tax was unconstitutional, and no claim having been made to the collector of the port of New York that the taxpayer was acting under restraint and yielding only to enable his ship to depart, recovery was denied because the tax was not paid under duress, even though clearance papers could not be procured without the delivery to the collector of the port of outward foreign manifests of cargo properly stamped, and even though the master of a vessel failing to deliver the proper manifest and to obtain a clearance, was subject to a penalty.[879]

879 U. S. v. N. Y. & Cuba etc. Co., 200 U. S. 488.

CHAPTER 48

TAX ON EMPLOYMENT OF CHILD LABOR

This tax is a new feature of the internal revenue laws of the United States, designed to effect the abandonment of child labor in the establishments specified in the law. No exhaustive statement of the tax is intended to be made herein, but the features of the law will be briefly pointed out in order that readers may readily ascertain the apparent scope of the statute.[1]

Effective Date of the Act. The tax goes into effect beginning sixty days after the passage of the Revenue Act of 1918.[2] The Revenue Act of 1918 was signed by the President on February 24, 1919, and the effective date is therefore April 25, 1919.

Persons to Whom the Tax Applies. The tax applies to any individual, corporation, partnership, association or company operating a (1) mine, (2) quarry, (3) mill, (4) cannery, (5) workshop, (6) factory or (7) manufacturing establishment situated in the United States (except only a boys' or girls' canning club duly recognized by a State Agricultural Department or United States Agricultural Department).[3]

MINE OR QUARRY. In the case of a mine or quarry, the tax applies if any child under the age of sixteen years has been employed or permitted to work therein.[4]

MILL, CANNERY, WORKSHOP, FACTORY OR MANUFACTURING ESTABLISHMENT. In the case of these establishments

1 Revenue Act of 1918, Title XII.
2 Id. § 1207.
3 Id. § 1200.
4 Id.

the tax applies if (a) any child between the ages of 14 and 16 (presumably both ages inclusive) has been employed or permitted to work more than eight hours in any day or more than six days in any week or before six o'clock a. m. or after seven o'clock p. m. and (b) if any child under the age of fourteen has been employed or permitted to work at all.[5]

Duration of Employment. Employment contrary to the provisions of the act for a single day is sufficient to impose the tax on the net profits for the whole taxable year. The first taxable year is a period beginning on April 25, 1919, and ending either on December 31, 1919, or on an earlier date if the taxpayer has a fiscal year ending between those dates. Thus if a taxpayer has a fiscal year ending April 30, its first taxable year will be April 25 to April 30, both dates inclusive, while if another taxpayer has no fiscal year its first taxable year will be from April 25, 1919, to December 31, 1919, both dates inclusive. If both taxpayers should employ child labor contrary to the Act on April 25, 1919, the first would be taxed on its net profits for six days and the second on its net profits for eight months and six days.[6]

Mistake as to Age of Child. If a child has been employed or permitted to work under a mistake of fact as to the age of such child, and without intention to evade the tax, said employment shall not cause the tax to be imposed.[7]

Certificate of Age. Any person subject to the provision of the law who in good faith obtains a certificate at the time of employment showing the child to be of such age as not to come within the purview of the law, and keeps such certificate on file, may rely in good faith on such certificate to relieve him from the tax. Such certificate is to be issued in such form, under such conditions and by such persons as may be prescribed by a board com-

[5] Id.
[6] See § 1200 and § 1207.
[7] § 1203 (b).

posed of the Secretary of the Treasury, the Commissioner of Internal Revenue and the Secretary of Labor. The board may also authorize the use of employment certificates or other similar papers as to the age of the child issued under the laws of any State designated by the board.[8]

Inspection of Establishments. The Commissioner, or any person authorized by him, may enter and inspect at any time any mine, quarry, mill, cannery, workshop, factory or manufacturing establishment. The Secretary of Labor, or any person duly authorized by him, shall have like authority to make inspections for the purpose of complying with a request of the Commissioner.[9]

Basis and Rate of Tax. The tax is imposed at the rate of 10% on the entire net profits received or accrued for any year in which child labor is employed for any period of time, as indicated in the law. The net profits are computed by deducting from the gross amount received or accrued during the taxable year from the sale or disposition of such products manufactured within the United States (a) the cost of raw materials entering into the production; (b) running expenses, including rentals, repairs, maintenance, heat, power, insurance, management, and a reasonable allowance for salaries and depreciation; (c) interest on money borrowed and used to meet the needs of the business; (d) taxes of all kinds paid during the taxable year with respect to the business or property relating to the production and (e) losses actually sustained within the taxable year in connection with the business of producing such products, including losses from fire, flood, storm or other casualties, not compensated for by insurance or otherwise. If the product is sold at less than the fair market price in such manner as to directly or indirectly benefit any person directly or indirectly interested in the business or with intent to cause such benefit, the tax is imposed on the gross amount received or

[8] § 1203 (a).
[9] §1206.

accrued from the sale or disposition during the period that any such sales took place.[10]

Returns to Be Filed. Every person subject to the provisions of the law (which seems to mean those who operate establishments of the kind enumerated in the law) is required to file a return annually showing the gross amount of income received or accrued during the year from the sale or disposition of the product of any mine, quarry, mill, cannery, workshop, factory or manufacturing establishment in which children have been employed subjecting him to the tax and the amounts allowed by the law to be deducted therefrom, and other particulars, in such form as the Commissioner may require. Such returns are to be filed on or before the first day of the third month following the close of each taxable year, with the local Collector of Internal Revenue. Extension of time to file returns may be granted by the collector in case of sickness or absence.[11]

Tax Due. The tax becomes due on or before thirty days from the date of the notice of assessment given to the taxpayer by the Commissioner.[12]

Penalties. The general penalties apply for failure to file returns, or pay the tax, or for filing false or fraudulent returns.[13] Refusal to permit entry or inspection of any establishment is punished by fine of not more than $1,000 or imprisonment for not more than one year, or both fine and imprisonment.[14]

10 §§ 1200, 1201, 1202.
11 § 1204; R. S. § 3176.
12 § 1205.
13 See Revenue Act of 1918, § 1308 and § 1317, containing R. S. § 3176 as amended.
14 § 1206.

REVENUE ACT OF 1918[1]

AN ACT TO PROVIDE REVENUE, AND FOR OTHER PURPOSES

ACT OF FEB. 24, 1919, PUBLIC No. 254

TITLE I—GENERAL DEFINITIONS

Section 1. That when used in this Act—

The term "person" includes partnerships and corporations, as well as individuals;

The term "corporation" includes associations, joint-stock companies, and insurance companies;

The term "domestic" when applied to a corporation or partnership means created or organized in the United States;

The term "foreign" when applied to a corporation or partnership means created or organized outside the United States;

The term "United States" when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia;

The term "Secretary" means the Secretary of the Treasury;

The term "Commissioner" means the Commissioner of Internal Revenue;

The term "collector" means collector of internal revenue;

The term "Revenue Act of 1916" means the Act entitled "An Act to increase the revenue, and for other purposes," approved September 8, 1916;

The term "Revenue Act of 1917" means the Act entitled "An Act to provide revenue to defray war expenses, and for other purposes," approved October 3, 1917;

1 Only those parts of the Act which apply to the taxes treated in this book are reprinted here.

The term "taxpayer" includes any person, trust or estate subject to a tax imposed by this Act;

The term "Government contract" means (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a subcontract made with a contractor performing such a contract if the products or services to be furnished under the subcontract are for the benefit of the United States. The term "Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive" when applied to a contract of the kind referred to in clause (a) of this paragraph, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law;

The term "military or naval forces of the United States" includes the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, and the Navy Nurse Corps, Female, but this shall not be deemed to exclude other units otherwise included within such term;

The term "present war" means the war in which the United States is now engaged against the German Government.

For the purposes of this Act the date of the termination of the present war shall be fixed by proclamation of the President.

TITLE II—INCOME TAX

Part I—General Provisions

DEFINITIONS

Sec. 200. That when used in this title—

The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under section 212 or section 232. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December. The first taxable year, to be called the taxable year 1918, shall be the calendar year 1918 or any fiscal year ending during the calendar year 1918;

The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate;

The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 221 or section 237;

The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive;

The term "paid," for the purposes of the deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212.

DIVIDENDS

Sec. 201. (a) That the term "dividend" when used in this title (except in paragraph (10) of subdivision (a) of section 234) means (1) any distribution made by a corporation, other than a personal service corporation, to its shareholders or members, whether in cash or in other property or in stock of the corporation, out of its earnings or profits accumulated since February 28, 1913, or (2) any such distribution made by a personal service corporation out of its earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.

(b) Any distribution shall be deemed to have been made from earnings or profits unless all earnings and profits have first been distributed. Any distribution made in the year 1918 or any year thereafter shall be deemed to have been made from earnings or profits accumulated since February 28, 1913, or, in the case of a personal service corporation, from the most recently accumulated earnings or profits; but any earnings or profits accumulated prior to March 1, 1913, may be distributed in stock dividends or otherwise, exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.

(c) A dividend paid in stock of the corporation shall be considered income to the amount of the earnings or profits distributed. Amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gains or profits.

(d) If any stock dividend (1) is received by a taxpayer between January 1 and November 1, 1918, both dates inclusive, or (2) is during such period bona fide authorized or declared, and entered on the books of the corporation, and is received by a taxpayer after November 1, 1918, and before the expiration of thirty days after passage of this Act, then such dividend shall, in the manner provided in section 206, be taxed to the recipient at the rates prescribed by law for the years in which the corporation accumulated the earnings or profits from which such dividend was paid, but the dividend shall be deemed to have been paid from the most recently accumulated earnings or profits.

(e) Any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period.

BASIS FOR DETERMINING GAIN OR LOSS

Sec. 202. (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203.

(b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair

market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

When in the case of any such reorganization, merger or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock or securities exchanged, a like amount in par or face value of the new stock or securities received shall be treated as taking the place of the stock or securities exchanged, and the amount of the excess in par or face value shall be treated as a gain to the extent that the fair market value of the new stock or securities is greater than the cost (or if acquired prior to March 1, 1913, the fair market value as of that date) of the stock or securities exchanged.

INVENTORIES

Sec. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

NET LOSSES

Sec. 204. (a) That as used in this section the term "net loss" refers only to net losses resulting from either (1) the operation of any business regularly carried on by the taxpayer, or (2) the bona fide sale by the taxpayer of plant, buildings, machinery, equipment or other facilities, constructed, installed or acquired by the taxpayer on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war; and when so resulting means the excess of the deductions allowed by law (excluding in the case of corporations amounts allowed as a deduction under paragraph (6) of subdivision (a) of section 234) over the sum of the gross income plus any interest received free from taxation both under this title and under Title III.

(b) If for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount of such net loss shall under regulations prescribed by the Commissioner with the approval of the Secretary be deducted from the net income of the taxpayer for the preceding taxable year; and the taxes imposed by this title and by Title III for such preceding taxable year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. If such net loss is in excess of the net income for such preceding taxable year, the amount of such excess shall under regulations prescribed by the Commissioner with the approval of the Secretary be allowed as a deduction in computing the net income for the succeeding taxable year.

(c) The benefit of this section shall be allowed to the members of a partnership and the beneficiaries of an estate or trust under regulations prescribed by the Commissioner with the approval of the Secretary.

FISCAL YEAR WITH DIFFERENT RATES

Sec. 205. (a) That if a taxpayer makes return for a fiscal year beginning in 1917 and ending in 1918, his tax under this title for the first taxable year shall be the sum of: (1) the same proportion of a tax for the entire period computed under Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917 and under Title I of the Revenue Act of 1917, which the portion of such period falling within the calendar year 1917 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates for the calendar year 1918 which the portion of such period falling within the calendar year 1918 is of the entire period: *Provided,* That in the case of a personal service corporation the amount to be paid shall be only that specified in clause (1).

Any amount heretofore or hereafter paid on account of the tax imposed for such fiscal year by Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917, and by Title I of the Revenue Act of 1917, shall be credited towards the payment of the tax imposed for such fiscal year by this act, and if the amount so paid exceeds the amount of such tax imposed by this act, or, in the case of a personal service corporation, the amount specified in clause (1), the

excess shall be credited or refunded in accordance with the provisions of section 252.

(b) If a taxpayer makes a return for a fiscal year beginning in 1918 and ending in 1919, the tax under this title for such fiscal year shall be the sum of: (1) the same proportion of a tax for the entire period computed under this title at the rates specified for the calendar year of 1918 which the portion of such period falling within the calendar year 1918 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates specified for the calendar year 1919 which the portion of such period falling within the calendar year 1919 is of the entire period.

(c) If a fiscal year of a partnership begins in 1917 and ends in 1918 or begins in 1918 and ends in 1919, then notwithstanding the provisions of subdivision (b) of section 218, (1) the rates for the calendar year during which such fiscal year begins shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such calendar year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year: *Provided*, That in the case of a personal service corporation with respect to a fiscal year beginning in 1917 and ending in 1918, the amount specified in clause (1) shall not be subject to normal tax.

PARTS OF INCOME SUBJECT TO RATES FOR DIFFERENT YEARS

Sec. 206. That whenever parts of a taxpayer's income are subject to rates for different calendar years, the part subject to the rates for the most recent calendar year shall be placed in the lower brackets of the rate schedule provided in this title, the part subject to the rates for the next preceding calendar year shall be placed in the next higher brackets of the rate schedule applicable to that year, and so on until the entire net income has been accounted for. In determining the income, any deductions, exemptions or credits of a kind not plainly and properly chargeable against the income taxable at rates for a preceding year shall first be applied against the income subject to rates for the most recent calendar year; but any balance thereof shall be applied against the income subject to the rates of the next preceding year or years until fully allowed.

PART II—INDIVIDUALS

NORMAL TAX

Sec. 210. That, in lieu of the taxes imposed by subdivision (a) of section 1 of the Revenue Act of 1916 and by section 1 of the Revenue Act of 1917, there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax at the following rates:

(a) For the calendar year 1918, 12 per centum of the amount of the net income in excess of the credits provided in section 216: *Provided*, That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 6 per centum;

(b) For each calendar year thereafter, 8 per centum of the amount of the net income in excess of the credits provided in section 216: *Provided*, That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 4 per centum.

SURTAX

Sec. 211. (a) That, in lieu of the taxes imposed by subdivision (b) of section 1 of the Revenue Act of 1916 and by section 2 of the Revenue Act of 1917, but in addition to the normal tax imposed by section 210 of this Act, there shall be levied, collected, and paid for each taxable year upon the net income of every individual, a surtax equal to the sum of the following:

1 per centum of the amount by which the net income exceeds $5,000 and does not exceed $6,000;

2 per centum of the amount by which the net income exceeds $6,000 and does not exceed $8,000;

3 per centum of the amount by which the net income exceeds $8,000 and does not exceed $10,000;

4 per centum of the amount by which the net income exceeds $10,000 and does not exceed $12,000;

5 per centum of the amount by which the net income exceeds $12,000 and does not exceed $14,000;

6 per centum of the amount by which the net income exceeds $14,000 and does not exceed $16,000;

7 per centum of the amount by which the net income exceeds $16,000 and does not exceed $18,000;

8 per centum of the amount by which the net income exceeds $18,000 and does not exceed $20,000;

9 per centum of the amount by which the net income exceeds $20,000 and does not exceed $22,000;

10 per centum of the amount by which the net income exceeds $22,000 and does not exceed $24,000;

11 per centum of the amount by which the net income exceeds $24,000 and does not exceed $26,000;

12 per centum of the amount by which the net income exceeds $26,000 and does not exceed $28,000;

13 per centum of the amount by which the net income exceeds $28,000 and does not exceed $30,000;

14 per centum of the amount by which the net income exceeds $30,000 and does not exceed $32,000;

15 per centum of the amount by which the net income exceeds $32,000 and does not exceed $34,000;

16 per centum of the amount by which the net income exceeds $34,000 and does not exceed $36,000;

17 per centum of the amount by which the net income exceeds $36,000 and does not exceed $38,000;

18 per centum of the amount by which the net income exceeds $38,000 and does not exceed $40,000;

19 per centum of the amount by which the net income exceeds $40,000 and does not exceed $42,000;

20 per centum of the amount by which the net income exceeds $42,000 and does not exceed $44,000;

21 per centum of the amount by which the net income exceeds $44,000 and does not exceed $46,000;

22 per centum of the amount by which the net income exceeds $46,000 and does not exceed $48,000;

23 per centum of the amount by which the net income exceeds $48,000 and does not exceed $50,000;

24 per centum of the amount by which the net income exceeds $50,000 and does not exceed $52,000;

25 per centum of the amount by which the net income exceeds $52,000 and does not exceed $54,000;

26 per centum of the amount by which the net income exceeds $54,000 and does not exceed $56,000;

27 per centum of the amount by which the net income exceeds $56,000 and does not exceed $58,000;

28 per centum of the amount by which the net income exceeds $58,000 and does not exceed $60,000;

29 per centum of the amount by which the net income exceeds $60,000 and does not exceed $62,000;

30 per centum of the amount by which the net income exceeds $62,000 and does not exceed $64,000;

31 per centum of the amount by which the net income exceeds $64,000 and does not exceed $66,000;

32 per centum of the amount by which the net income exceeds $66,000 and does not exceed $68,000;

33 per centum of the amount by which the net income exceeds $68,000 and does not exceed $70,000;

34 per centum of the amount by which the net income exceeds $70,000 and does not exceed $72,000;

35 per centum of the amount by which the net income exceeds $72,000 and does not exceed $74,000;

36 per centum of the amount by which the net income exceeds $74,000 and does not exceed $76,000;

37 per centum of the amount by which the net income exceeds $76,000 and does not exceed $78,000;

38 per centum of the amount by which the net income exceeds $78,000 and does not exceed $80,000;

39 per centum of the amount by which the net income exceeds $80,000 and does not exceed $82,000;

40 per centum of the amount by which the net income exceeds $82,000 and does not exceed $84,000;

41 per centum of the amount by which the net income exceeds $84,000 and does not exceed $86,000;

42 per centum of the amount by which the net income exceeds $86,000 and does not exceed $88,000;

43 per centum of the amount by which the net income exceeds $88,000 and does not exceed $90,000;

44 per centum of the amount by which the net income exceeds $90,000 and does not exceed $92,000;

45 per centum of the amount by which the net income exceeds $92,000 and does not exceed $94,000;

46 per centum of the amount by which the net income exceeds $94,000 and does not exceed $96,000;

47 per centum of the amount by which the net income exceeds $96,000 and does not exceed $98,000;

48 per centum of the amount by which the net income exceeds $98,000 and does not exceed $100,000;

52 per centum of the amount by which the net income exceeds $100,000 and does not exceed $150,000;

56 per centum of the amount by which the net income exceeds $150,000 and does not exceed $200,000;

60 per centum of the amount by which the net income exceeds $200,000 and does not exceed $300,000;

63 per centum of the amount by which the net income exceeds $300,000 and does not exceed $500,000;

64 per centum of the amount by which the net income exceeds $500,000 and does not exceed $1,000,000;

65 per centum of the amount by which the net income exceeds $1,000,000.

(b) In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this section attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest.

NET INCOME DEFINED

Sec. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226.

GROSS INCOME DEFINED

Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but

(b) Does not include the following items, which shall be exempt from taxation under this title:

(1) The proceeds of life insurance policies paid upon the death of the insured to individual beneficiaries or to the estate of the insured;

(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);

(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation; *Provided,* That every person owning any of the obligations, securities or bonds enumerated in clauses (a), (b), (c) and (d) shall, in return required by this title, submit a statement showing the number and amount of such obligations, securities and bonds owned by him and the income received therefrom, in such form and with such information as the Commissioner may require. In the case of obligations of the United States issued after Septem-

ber 1, 1917, and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer both under this title and under Title III;

(5) The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States;

(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;

(7) Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof.

Whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility, no tax shall be levied under the provisions of this title upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such State, Territory, District of Columbia, or political subdivision; but this provision is not intended to confer upon such person any financial gain or exemption or to relieve such person from the payment of a tax as provided for in this title upon the part or portion of such income to which such person is entitled under such contract;

(8) So much of the amount received during the present war by a person in the military or naval forces of the United States as salary or compensation in any form from the United States for active services in such forces, as does not exceed $3,500.

(c) In the case of nonresident alien individuals, gross income includes only the gross income from sources within the United States, including interest on bonds, notes, or other interest-bearing obliga-

tions of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States.

DEDUCTIONS ALLOWED

Sec. 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity;

(2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt from taxation under this title as income to the taxpayer, or, in the case of a nonresident alien individual, the proportion of such interest which the amount of his gross income from sources within the United States bears to the amount of his gross income from all sources within and without the United States;

(3) Taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits and excess-profits taxes; or (b) by the authority of any of its possessions, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 222; or (c) by the authority of any State or Territory, or any county, school district, municipality, or other taxing subdivision of any State or Territory, not including those assessed against local benefits of a kind tending to increase the value of the property assessed; or (d) in the case of a citizen or resident of the United States, by the authority of any foreign country, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 222; or (e) in the case of a non-resident alien individual, by the authority of any foreign country (except income, war-profits and excess-profits taxes, and taxes assessed against local benefits of a kind tending to increase the value of the property assessed), upon property or business;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;

(5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; but in the case of a nonresident alien individual only as to such transactions within the United States;

(6) Losses sustained during the taxable year of property not connected with the trade or business (but in the case of a nonresident alien individual only property within the United States) if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise;

(7) Debts ascertained to be worthless and charged off within the taxable year;

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(9) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the present war, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Acts of Congress as a deduction in computing net income. At any time within three years after the termination of the present war, the Commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the taxes imposed by this title and by Title III for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252;

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties

acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

(11) Contributions or gifts made within the taxable year to corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or to the special fund for vocational rehabilitation authorized by section 7 of the Vocational Rehabilitation Act, to an amount not in excess of 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary. In the case of a nonresident alien individual this deduction shall be allowed only as to contributions or gifts made to domestic corporations, or to such vocational rehabilitation fund;

(12) (a) At the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by such claim shall not be required until the claim is decided, but the taxpayer shall accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the Commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim is disallowed then the remainder

of the tax due shall on notice and demand by the collector be paid by the taxpayer with interest at the rate of 1 per centum per month from the time the tax would have been due had no such claim been filed. If it is shown to the satisfaction of the Commissioner that such substantial loss has been sustained, then in computing the tax imposed by this title the amount of such loss shall be deducted from the net income. (b) If no such claim is filed, but it is shown to the satisfaction of the Commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described then the amount of such loss shall be deducted from the net income for the taxable year 1918 and the tax imposed by this title for such year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

(b) In the case of a nonresident alien individual the deductions allowed in paragraphs (1), (4), (7), (8), (9), (10), and (12), and clause (e) of paragraph (3), of subdivision (a) shall be allowed only if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

ITEMS NOT DEDUCTIBLE

Sec. 215. That in computing net income no deduction shall in any case be allowed in respect of—

(a) Personal, living, or family expenses;

(b) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(c) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made; or

(d) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

CREDITS ALLOWED

Sec. 216. That for the purpose of the normal tax only there shall be allowed the following credits:

(a) The amount received as dividends from a corporation which is taxable under this title upon its net income, and amounts received as dividends from a personal service corporation out of earnings or profits upon which income tax has been imposed by Act of Congress;

(b) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 213;

(c) In the case of a single person, a personal exemption of $1,000, or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,000. A husband and wife living together shall receive but one personal exemption of $2,000 against their aggregate net income; and in case they make separate returns, the personal exemption of $2,000 may be taken by either or divided between them;

(d) $200 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer, if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective.

(e) In the case of a nonresident alien individual who is a citizen or subject of a country which imposes an income tax, the credits allowed in subdivisions (c) and (d) shall be allowed only if such country allows a similar credit to citizens of the United States not residing in such country.

NONRESIDENT ALIENS—ALLOWANCE OF DEDUCTIONS AND CREDITS

Sec. 217. That a nonresident alien individual shall receive the benefit of the deductions and credits allowed in this title only by filing or causing to be filed with the collector a true and accurate return of his total income received from all sources corporate or otherwise in the United States, in the manner prescribed by this title, including therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits: *Provided*, That the benefit of the credits allowed in subdivisions (c) and (d) of section 216 may, in the discretion of the Commissioner, and except as otherwise provided in subdivision (e) of that section, be received by filing a claim therefor with the withholding agent. In case of failure to file a return, the collector shall

collect the tax on such income, and all property belonging to such nonresident alien individual shall be liable to distraint for the tax.

PARTNERSHIPS AND PERSONAL SERVICE CORPORATIONS

Sec. 218. (a) That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership.

(b) If a fiscal year of a partnership ends during a calendar year for which the rates of tax differ from those for the preceding calendar year, then (1) the rates for such preceding calendar year shall apply to an amount of each partner's share of such partnership net income equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to the remainder.

(c) In the case of an individual member of a partnership which makes return for a fiscal year beginning in 1917 and ending in 1918, his proportionate share of any excess-profits tax imposed upon the partnership under the Revenue Act of 1917 with respect to that part of such fiscal year falling in 1917, shall, for the purpose of determining the tax imposed by this title, be credited against that portion of the net income embraced in his personal return for the taxable year 1918 to which the rates for 1917 apply.

(d) The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212 except that the deduction provided in paragraph (11) of subdivision (a) of section 214 shall not be allowed.

(e) Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be

taxed on the same manner as the members of partnerships. All the provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to personal service corporations and the stockholders thereof: *Provided*, That for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares.

ESTATES AND TRUSTS

Sec. 219. (a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—

(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

(2) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(3) Income held for future distribution under the terms of the will or trust; and

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that there shall also be allowed as a deduction (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid to or permanently set aside for the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, or any corporation organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; and in cases under paragraph (4) of subdivision (a) of this section the fiduciary shall include in the return a statement of each beneficiary's distributive

share of such net income, whether or not distributed before the close of the taxable year for which the return is made.

(c) In cases under paragraph (1), (2), or (3) of subdivision (a) the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary, except that in determining the net income of the estate of any deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir or other beneficiary. In such cases the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under section 216.

(d) In cases under paragraph (4) of subdivision (a), and in the case of any income of an estate during the period of administration or settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary, the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary his distributive share, whether distributed or not, of the net income of the estate or trust for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the estate or trust is computed, then his distributive share of the net income of the estate or trust for any accounting period of such estate or trust ending within the fiscal or calendar year upon the basis of which such beneficiary's net income is computed. In such cases the beneficiary shall, for the purpose of the normal tax, be allowed as credits in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the estate or trust.

PROFITS OF CORPORATIONS TAXABLE TO STOCKHOLDERS

Sec. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, such corporation shall not be subject to the tax imposed by section 230, but the stockholders or members thereof shall be subject to taxation under this title in the same manner as provided in subdivision (e) of section 218 in the case of stockholders of a personal service corporation, except that the tax imposed by Title III shall be deducted from the net income of the

corporation before the computation of the proportionate share of each stockholder or member. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

PAYMENT OF TAX AT SOURCE

Sec. 221. (a) That all individuals, corporations and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States, having the control, receipt, custody, disposal, or payment, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, of any nonresident alien individual (other than income received as dividends from a corporation which is taxable under this title upon its net income) shall (except in the cases provided for in subdivision (b) and except as otherwise provided in regulations prescribed by the Commissioner under section 217) deduct and withhold from such annual or periodical gains, profits, and income a tax equal to 8 per centum thereof: *Provided*, That the Commissioner may authorize such tax to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.

(b) In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States,

the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods and whether payable to a nonresident alien individually or to an individual citizen or resident of the United States or to a partnership: *Provided,* That the Commissioner may authorize such tax to be deducted and withheld in the case of interest upon any such bonds, mortgages, deeds of trust or other obligations, the owners of which are not known to the withholding agent. Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1, a signed notice in writing claiming the benefit of the credits provided in subdivisions (c) and (d) of section 216; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Commissioner under section 217.

(c) Every individual, corporation, or partnership required to deduct and withhold any tax under this section shall make return thereof on or before March first of each year and shall on or before June fifteenth pay the tax to the official of the United States Government authorized to receive it. Every such individual, corporation, or partnership is hereby made liable for such tax and is hereby indemnified against the claims and demands of any individual, corporation, or partnership for the amount of any payments made in accordance with the provisions of this section.

(d) Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

(e) If any tax required under this section to be deducted and withheld is paid by the recipient of the income, it shall not be re-collected from the withholding agent; nor in cases in which the tax is so paid shall any penalty be imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

CREDIT FOR TAXES

Sec. 222. (a) That the tax computed under Part II of this title shall be credited with:

(1) In the case of a citizen of the United States, the amount of

any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States; and

(2) In the case of a resident of the United States, the amount of any such taxes paid during the taxable year to any possession of the United States; and

(3) In the case of an alien resident of the United States who is a citizen or subject of a foreign country, the amount of any such taxes paid during the taxable year to such country, upon income derived from sources therein, if such country, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(b) If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Commissioner who shall redetermine the amount of the tax due under Part II of this title for the year or years affected, and the amount of tax due upon such redetermination, of any, shall be paid by the taxpayer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the Commissioner in such penal sum as the Commissioner may require, conditioned for the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources within such foreign country or such possession of the United States, and all other information necessary for the computation of such credits.

INDIVIDUAL RETURNS

Sec. 223. That every individual having a net income for the taxable year of $1,000 or over if single or if married and not living

with husband or wife, or of $2,000 or over if married and living with husband or wife, shall make under oath a return stating specifically the items of his gross income and the deductions and credits allowed by this title. If a husband and wife living together have an aggregate net income of $2,000 or over, each shall make such a return unless the income of each is included in a single joint return.

If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.

PARTNERSHIP RETURNS

Sec. 224. That every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

FIDUCIARY RETURNS

Sec. 225. That every fiduciary (except receivers appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for the individual, estate or trust for which he acts (1) if the net income of such individual is $1,000 or over if single or if married and not living with husband or wife, or $2,000 or over if married and living with husband or wife, or (2) if the net income of such estate or trust is $1,000 or over or if any beneficiary of such estate or trust is a nonresident alien, stating specifically the items of the gross income and the deductions and credits allowed by this title. Under such regulations as the Commissioner with the approval of the Secretary may prescribe, a return made by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides shall be a sufficient compliance with the above requirement, The fiduciary shall make oath that he has sufficient knowledge of the affairs of such individual, estate or trust to enable him to make the return, and that the same is, to the best of his knowledge and belief, true and correct.

Fiduciaries required to make returns under this Act shall be subject to all the provisions of this Act which apply to individuals.

RETURNS WHEN ACCOUNTING PERIOD CHANGED

SEC. 226. That if a taxpayer, with the approval of the Commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December thirty-first. If the change is from calendar year to fiscal year, a separate return shall be made for the period between the close of the last calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year. If a taxpayer making his first return for income tax keeps his accounts on the basis of a fiscal year he shall make a separate return for the period between the beginning of the calendar year in which such fiscal year ends and the end of such fiscal year.

In all of the above cases the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included; and the credits provided in subdivisions (c) and (d) of section 216 shall be reduced respectively to amounts which bear the same ratio to the full credits provided in such subdivisions as the number of months in such period bears to twelve months.

TIME AND PLACE FOR FILING RETURNS

SEC. 227. (a) That returns shall be made on or before the fifteenth day of the third month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the fifteeth day of March. The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

(b) Returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

UNDERSTATEMENT IN RETURNS

Sec. 228. That if the collector or deputy collector has reason to believe that the amount of any income returned is understated, he shall give due notice to the taxpayer making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated, may increase the same accordingly. Such taxpayer may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector may appeal to the Commissioner for his decision, under such rules of procedure as may be prescribed by the Commissioner with the approval of the Secretary.

PART III—CORPORATIONS

TAX ON CORPORATIONS

Sec. 230. (a) That, in lieu of the taxes imposed by section 10 of the Revenue Act of 1916, as amended by the Revenue Act of 1917, and by section 4 of the Revenue Act of 1917, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

(1) For the calendar year 1918, 12 per centum of the amount of the net income in excess of the credits provided in section 236; and

(2) For each calendar year thereafter, 10 per centum of such excess amount.

(b) For the purposes of the Act approved March 21, 1918, entitled "An Act to provide for the operation of transportation systems while under Federal control, for the just compensation of their owners, and for other purposes," five-sixths of the tax imposed by paragraph (1) of subdivision (a) and four-fifths of the tax imposed by paragraph (2) of subdivision (a) shall be treated as levied by an Act in amendment of Title I of the Revenue Act of 1917.

CONDITIONAL AND OTHER EXEMPTIONS

Sec. 231. That the following organizations shall be exempt from taxation under this title—

(1) Labor, agricultural, or horticultural organizations;

(2) Mutual savings banks not having a capital stock represented by shares;

(3) Fraternal beneficiary societies, orders, or associations, (a)

operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

(4) Domestic building and loan associations and cooperative banks without capital stock organized and operated for mutual purposes and without profit;

(5) Cemetery companies owned and operated exclusively for the benefit of their members;

(6) Corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(7) Business leagues, chambers of commerce, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare;

(9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member;

(10) Farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting expenses;

(11) Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them;

(12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title;

(13) Federal land banks and national farm-loan associations as provided in section 26 of the act approved July 17, 1916, entitled "An Act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United

States bonds, to create Government depositaries and financial agents for the United States, and for other purposes'';

(14) Personal service corporations.

NET INCOME DEFINED

Sec. 232. That in the case of a corporation subject to the tax imposed by section 230 the term ''net income'' means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226.

GROSS INCOME DEFINED

Sec. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term ''gross income'' means the gross income as defined in section 213, except that:

(1) In the case of life insurance companies there shall not be included in gross income such portion of any actual premium received from any individual policyholder as is paid back or credited to or treated as an abatement of premium of such policyholder within the taxable year.

(2) Mutual marine insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance.

(b) In the case of a foreign corporation gross income includes only the gross income from sources within the United States, including the interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, and including all amounts received (although paid under a contract for the sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States.

DEDUCTIONS ALLOWED

Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, in-

(10) In the case of insurance companies, in addition to the above: (a) The net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds); and (b) the sums other than dividends paid within the taxable year on policy and annuity contracts;

(11) In the case of corporations issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan continuing for life and not subject to cancellation, in addition to the above, such portion of the net addition (not required by law) made within the taxable year to reserve funds as the Commissioner finds to be required for the protection of the holders of such policies only;

(12) In the case of mutual marine insurance companies, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment and the payment thereof;

(13) In the case of mutual insurance companies (other than mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, (unless otherwise allowed under such paragraphs) the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves;

(14) (a) At the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. In such case payment of the amount of the tax covered by such claim shall not be required until the claim is decided, but the taxpayer shall accompany his claim with a bond in double the amount of the tax covered by the claim, with sureties satisfactory to the Commissioner, conditioned for the payment of any part of such tax found to be due, with interest. If any part of such claim is disallowed then the remainder of the tax due shall on notice and demand by the collector be paid by the

taxpayer with interest at the rate of 1 per centum per month from the time the tax would have been due had no such claim been filed. If it is shown to the satisfaction of the Commissioner that such substantial loss has been sustained, then in computing the taxes imposed by this title and by Title III the amount of such loss shall be deducted from the net income. (b) If no such claim is filed, but it is shown to the satisfaction of the Commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described then the amount of such loss shall be deducted from the net income for the taxable year 1918 and the taxes imposed by this title and by Title III for such year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

(b) In the case of a foreign corporation the deductions allowed in subdivision (a), except those allowed in paragraph (2) and in clauses (a), (b), and (c) of paragraph (3), shall be allowed only if and to the extent that they are connected with income arising from a source within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

ITEMS NOT DEDUCTIBLE

Sec. 235. That in computing net income no deduction shall in any case be allowed in respect of any of the items specified in section 215.

CREDITS ALLOWED

Sec. 236. That for the purpose only of the tax imposed by section 230 there shall be allowed the following credits:

(a) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 233;

(b) The amount of any taxes imposed by Title III for the same taxable year: *Provided*, That in the case of a corporation which makes return for a fiscal year beginning in 1917 and ending in 1918, in computing the tax as provided in subdivision (a) of section 205,

the tax computed for the entire period under Title II of the Revenue Act of 1917 shall be credited against the net income computed for the entire period under Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917 and under Title I of the Revenue Act of 1917, and the tax computed for the entire period under Title III of this Act at the rates prescribed for the calendar year 1918 shall be credited against the net income computed for the entire period under this title; and

(c) In the case of a domestic corporation, $2,000.

PAYMENT OF TAX AT SOURCE

Sec. 237. That in the case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items of income as is provided in section 221 a tax equal to 10 per centum thereof, and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section: *Provided,* That in the case of interest described in subdivision (b) of that section the deduction and withholding shall be at the rate of 2 per centum.

CREDIT FOR TAXES

Sec. 238. (a) That in the case of a domestic corporation the total taxes imposed for the taxable year by this title and by Title III shall be credited with the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States.

If accrued taxes when paid differ from the amounts claimed as credits by the corporation, or if any tax paid is refunded in whole or in part, the corporation shall at once notify the Commissioner who shall redetermine the amount of the taxes due under this title and under Title III for the year or years affected, and the amount of taxes due upon such redetermination, if any, shall be paid by the corporation upon notice and demand by the collector, or the amount of taxes overpaid, if any, shall be credited or refunded to the corporation in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the corporation to give a bond with sureties satisfactory to and to be approved

by him in such penal sum as he may require, conditioned for the payment by the taxpayer of any amount of taxes found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(b) This credit shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources within such foreign country or such possession of the United States, as the case may be, and all other information necessary for the computation of such credit.

(c) If a domestic corporation makes a return for a fiscal year beginning in 1917 and ending in 1918, only that proportion of this credit shall be allowed which the part of such period within the calendar year 1918 bears to the entire period.

CORPORATION RETURNS

Sec. 239. That every corporation subject to taxation under this title and every personal service corporation shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title. The return shall be sworn to by the president, vice president, or other principal officer and by the treasurer or assistant treasurer. If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return shall be made by the agent. In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.

Returns made under this section shall be subject to the provisions of sections 226 and 228. When return is made under section 226 the credit provided in subdivision (c) of section 236 shall be reduced to an amount which bears the same ratio to the full credit therein provided as the number of months in the period for which such return is made bears to twelve months.

CONSOLIDATED RETURNS

Sec. 240. (a) That corporations which are affiliated within the meaning of this section shall, under regulations to be prescribed

by the Commissioner with the approval of the Secretary, make a consolidated return of net income and invested capital for the purposes of this title and Title III, and the taxes thereunder shall be computed and determined upon the basis of such return: *Provided*, That there shall be taken out of such consolidated net income and invested capital, the net income and invested capital of any such affiliated corporation organized after August 1, 1914, and not successor to a then existing business, 50 per centum or more of whose gross income consists of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive. In such case the corporation so taken out shall be separately assessed on the basis of its own invested capital and net income and the remainder of such affiliated group shall be assessed on the basis of the remaining consolidated invested capital and net income.

In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit of $2,000 (as provided in section 236); in computing the war-profits credit (as provided in section 311) only one specific exemption of $3,000; and in computing the excess-profits credit (as provided in section 312) only one specific exemption of $3,000.

(b) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

(c) For the purposes of section 238 a domestic corporation which owns a majority of the voting stock of a foreign corporation shall be deemed to have paid the same proportion of any income, war-profits and excess-profits taxes paid (but not including taxes accrued) by such foreign corporation during the taxable year to any foreign country or to any possession of the United States upon income derived from sources without the United States, which the amount of any dividends (not deductible under section 234) received by such domestic corporation from such foreign corporation during the taxable year bears to the total taxable income of such foreign corpora-

tion upon or with respect to which such taxes were paid: *Provided*, That in no such case shall the amount of the credit for such taxes exceed the amount of such dividends (not deductible under section 234) received by such domestic corporation during the taxable year.

TIME AND PLACE FOR FILING RETURNS

Sec. 241. (a) That returns of corporations shall be made at the same time as is provided in subdivision (a) of section 227.

(b) Returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

PART IV—ADMINISTRATIVE PROVISIONS

PAYMENT OF TAXES

Sec. 250. (a) That except as otherwise provided in this section and sections 221 and 237 the tax shall be paid in four installments, each consisting of one-fourth of the total amount of the tax. The first installment shall be paid at the time fixed by law for filing the return, and the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after the time fixed by law for filing the return. Where an extension of time for filing a return is granted the time for payment of the first installment shall be postponed until the date of the expiration of the period of the extension, but the time for payment of the other installments shall not be postponed unless the Commissioner so provides in granting the extension. In any case in which the time for the payment of any installment is at the request of the taxpayer thus postponed, there shall be added as part of such installment interest thereon at the rate of ½ of 1 per centum per month from the time it would have been due if no extension had been granted until paid. If any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector.

The tax may at the option of the taxpayer be paid in a single payment instead of in installments, in which case the total amount shall be paid on or before the time fixed by law for filing the return,

or, where an extension of time for filing the return has been granted, on or before the expiration of the period of such extension.

(b) As soon as practicable after the return is filed, the Commissioner shall examine it. If it then appears that the correct amount of the tax is greater or less than that shown in the return, the installments shall be recomputed. If the amount already paid exceeds that which should have been paid on the basis of the installments as recomputed, the excess so paid shall be credited against the subsequent installments; and if the amount already paid exceeds the correct amount of the tax, the excess shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

If the amount already paid is less than that which should have been paid, the difference shall, to the extent not covered by any credits then due to the taxpayer under section 252, be paid upon notice and demand by the collector. In such case if the return is made in good faith and the understatement of the amount in the return is not due to any fault of the taxpayer, there shall be no penalty because of such understatement. If the understatement is due to negligence on the part of the taxpayer, but without intent to defraud, there shall be added as part of the tax 5 per centum of the total amount of the deficiency, plus interest at the rate of 1 per centum per month on the amount of the deficiency of each installment from the time the installment was due.

If the understatement is false or fraudulent with intent to evade the tax, then, in lieu of the penalty provided by section 3176 of the Revised Statutes, as amended, for false or fraudulent returns willfully made, but in addition to other penalties provided by law for false or fraudulent returns, there shall be added as part of the tax 50 per centum of the amount of the deficiency.

(c) If the return is made pursuant to section 3176 of the Revised Statutes as amended, the amount of tax determined to be due under such return shall be paid upon notice and demand by the collector.

(d) Except in the case of false or fraudulent returns with intent to evade the tax, the amount of tax due under any return shall be determined and assessed by the Commissioner within five years after the return was due or was made, and no suit or proceeding for the collection of any tax shall be begun after the expiration of five years after the date when the return was due or was made. In the case of such false or fraudulent returns, the amount of tax due may be determined at any time after the return is filed, and the tax may be collected at any time after it becomes due.

(e) If any tax remains unpaid after the date when it is due, and

for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, there shall be added as part of the tax the sum of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due: *Provided*, That as to any such amount which is the subject of a bona fide claim for abatement such sum of 5 per centum shall not be added and the interest from the time the amount was due until the claim is decided shall be at the rate of ½ of 1 per centum per month.

In the case of the first installment provided for in subdivision (a) the instructions printed on the return shall be deemed sufficient notice of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return shall be deemed sufficient notice of the amount due.

(f) In any case in which in order to enforce payment of a tax it is necessary for a collector to cause a warrant of distraint to be served, there shall also be added as part of the tax the sum of $5.

(g) If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner shall declare the taxable period for such taxpayer terminated at the end of the calendar month then last past and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of the Commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A taxpayer who is not in default in making any return or paying income, war-profits, or excess-profits tax under any Act of Congress may furnish to the United States, under regulations to be prescribed by the Commissioner with the approval of the Secretary, security approved by the Commissioner that he will duly make the return next thereafter required to be filed and pay the tax next there-

after required to be paid. The Commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the provisions of this subdivision, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him under any Act of Congress. If security is approved and accepted pursuant to the provisions of this subdivision and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any proceedings under the provisions of this subdivision prior to the expiration of the time otherwise allowed for paying such respective taxes.

RECEIPTS FOR TAXES

Sec. 251. That every collector to whom any payment of any tax is made under the provisions of this title shall upon request give to the person making such payment a full written or printed receipt, stating the amount paid and the particular account for which such payment was made; and whenever any debtor pays taxes on account of payments made or to be made by him to separate creditors the collector shall, if requested by such debtor, give a separate receipt for the tax paid on account of each creditor in such form that the debtor can conveniently produce such receipts separately to his several creditors in satisfaction of their respective demands up to the amounts stated in the receipts; and such receipt shall be sufficient evidence in favor of such debtor to justify him in withholding from his next payment to his creditor the amount therein stated; but the creditor may, upon giving to his debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting the amount of tax paid as aforesaid (specifying the same) as a further satisfaction of the debt to that amount, require the surrender to him of such collector's receipt.

REFUNDS

Sec. 252. That if, upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," the Act of October 3, 1913, entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," the Revenue Act of

1916, as amended, or the Revenue Act of 1917, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the taxpayer: *Provided*, That no such credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration of such five years a claim therefor is filed by the taxpayer.

PENALTIES

Sec. 253. That any individual, corporation, or partnership required under this title to pay or collect any tax, to make a return or to supply information, who fails to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, shall be liable to a penalty of not more than $1,000. Any individual, corporation, or partnership, or any officer or employee of any corporation or member or employee of a partnership, who willfully refuses to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, or who willfully attempts in any manner to defeat or evade the tax imposed by this title, shall be guilty of a misdemeanor and shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

RETURNS OF PAYMENTS OF DIVIDENDS

Sec. 254. That every corporation subject to the tax imposed by this title and every personal service corporation shall, when required by the Commissioner, render a correct return duly verified under oath, of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the amount of dividends paid to him.

RETURNS OF BROKERS

Sec. 255. That every individual, corporation, or partnership doing business as a broker shall, when required by the Commissioner, ren-

der a correct return duly verified under oath, under such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe, showing the names of customers for whom such individual, corporation, or partnership has transacted any business, with such details as to the profits, losses, or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner to determine whether all income tax due on profits or gains of such customers has been paid.

INFORMATION AT SOURCE

Sec. 256. That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers, making payment to another individual, corporation, or partnership, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments described in sections 254 and 255), of $1,000 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, and (2) in the case of collections of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by individuals, corporations, or partnerships, undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange.

When necessary to make effective the provisions of this section the name and address of the recipient of income shall be furnished upon demand of the individual, corporation, or partnership paying the income.

The provisions of this section shall apply to the calendar year 1918 and each calendar year thereafter, but shall not apply to the payment of interest on obligations of the United States.

RETURNS TO BE PUBLIC RECORDS

Sec. 257. That returns upon which the tax has been determined by the Commissioner shall constitute public records; but they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President: *Provided,* That the proper officers of any State imposing an income tax may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe: *Provided further,* That all bona fide stockholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries. Any stockholder who pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding one year, or both.

The Commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal-revenue district and in such other places as he may determine, lists containing the names and the post-office addresses of all individuals making income-tax returns in such district.

PUBLICATION OF STATISTICS

Sec. 258. That the Commissioner, with the approval of the Secretary, shall prepare and publish annually statistics reasonably available with respect to the operation of the income, war-profits and excess-profits-tax laws, including classifications of taxpayers and of income, the amounts allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable.

COLLECTION OF FOREIGN ITEMS

Sec. 259. That all individuals, corporations, or partnerships undertaking as a matter of business or for profit the collection of

der a correct return duly verified under oath, under such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe, showing the names of customers for whom such individual, corporation, or partnership has transacted any business, with such details as to the profits, losses, or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner to determine whether all income tax due on profits or gains of such customers has been paid.

INFORMATION AT SOURCE

Sec. 256. That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers, making payment to another individual, corporation, or partnership, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments described in sections 254 and 255), of $1,000 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, and (2) in the case of collections of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by individuals, corporations, or partnerships, undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange.

When necessary to make effective the provisions of this section the name and address of the recipient of income shall be furnished upon demand of the individual, corporation, or partnership paying the income.

The provisions of this section shall apply to the calendar year 1918 and each calendar year thereafter, but shall not apply to the payment of interest on obligations of the United States.

RETURNS TO BE PUBLIC RECORDS

Sec. 257. That returns upon which the tax has been determined by the Commissioner shall constitute public records; but they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President: *Provided,* That the proper officers of any State imposing an income tax may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe: *Provided further,* That all bona fide stockholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries. Any stockholder who pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding one year, or both.

The Commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal-revenue district and in such other places as he may determine, lists containing the names and the post-office addresses of all individuals making income-tax returns in such district.

PUBLICATION OF STATISTICS

Sec. 258. That the Commissioner, with the approval of the Secretary, shall prepare and publish annually statistics reasonably available with respect to the operation of the income, war-profits and excess-profits-tax laws, including classifications of taxpayers and of income, the amounts allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable.

COLLECTION OF FOREIGN ITEMS

Sec. 259. That all individuals, corporations, or partnerships undertaking as a matter of business or for profit the collection of

foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the Commissioner and shall be subject to such regulations enabling the Government to obtain the information required under this title as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both.

CITIZENS OF UNITED STATES POSSESSIONS

Sec. 260. That any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, shall be subject to taxation under this title only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources.

PORTO RICO AND PHILIPPINE ISLANDS

Sec. 261. That in Porto Rico and the Philippine Islands the income tax shall be levied, assessed, collected, and paid in accordance with the provisions of the Revenue Act of 1916 as amended.

Returns shall be made and taxes shall be paid under Title I of such Act in Porto Rico or the Philippine Islands, as the case may be, by (1) every individual who is a citizen or resident of Porto Rico or the Philippine Islands or derives income from sources therein, and (2) every corporation created or organized in Porto Rico or the Philippine Islands or deriving income from sources therein. An individual who is neither a citizen nor a resident of Porto Rico or the Philippine Islands but derives income from sources therein, shall be taxed in Porto Rico or the Philippine Islands as a nonresident alien individual, and a corporation created or organized outside Porto Rico or the Philippine Islands and deriving income from sources therein shall be taxed in Porto Rico or the Philippine Islands as a foreign corporation. For the purposes of section 216 and of paragraph (6) of subdivision (a) of section 234 a tax imposed in Porto Rico or the Philippine Islands upon the net income of a corporation shall not be deemed to be a tax under this title.

The Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Porto Rico or the Philippine Islands, respectively.

TITLE III—WAR-PROFITS AND EXCESS-PROFITS TAX

PART I—GENERAL DEFINITIONS

Sec. 300. That when used in this title the terms "taxable year," "fiscal year," "personal service corporation," "paid or accrued," and "dividends" shall have the same meaning as provided for the purposes of income tax in section 200 and 201. The first taxable year for the purposes of this title shall be the same as the first taxable year for the purposes of the income tax under Title II.

PART II—IMPOSITION OF TAX

Sec. 301. (a) That in lieu of the tax imposed by Title II of the Revenue Act of 1917, but in addition to the other taxes imposed by this Act, there shall be levied, collected, and paid for the taxable year 1918 upon the net income of every corporation a tax equal to the sum of the following:

FIRST BRACKET

30 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

SECOND BRACKET

65 per centum of the amount of the net income in excess of 20 per centum of the invested capital;

THIRD BRACKET

The sum, if any, by which 80 per centum of the amount of the net income in excess of the war-profits credit (determined under section 311) exceeds the amount of the tax computed under the first and second brackets.

(b) For the taxable year 1919 and each taxable year thereafter

there shall be levied, collected, and paid upon the net income of every corporation (except corporations taxable under subdivision (c) of this section) a tax equal to the sum of the following:

FIRST BRACKET

20 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

SECOND BRACKET

40 per centum of the amount of the net income in excess of 20 per centum of the invested capital.

(c) For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation which derives in such a year a net income of more than $10,000 from any Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, a tax equal to the sum of the following:

(1) Such a portion of a tax computed at the rates specified in subdivision (a) as the part of the net income attributable to such Government contract or contracts bears to the entire net income. In computing such tax the excess-profits credit and the war-profits credit applicable to the taxable year shall be used;

(2) Such a portion of a tax computed at the rates specified in subdivision (b) as the part of the net income not attributable to such Government contract or contracts bears to the entire net income.

For the purpose of determining the part of the net income attributable to such Government contract or contracts, the proper apportionment and allocation of the deductions with respect to gross income derived from such Government contract or contracts and from other sources, respectively, shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

(d) In any case where the full amount of the excess-profit credit is not allowed under the first bracket of subdivision (a) or (b), by reason of the fact that such credit is in excess of 20 per centum of the invested capital, the part not so allowed shall be deducted from the amount in the second bracket.

(e) For the purposes of the Act approved March 21, 1918, entitled "An Act to provide for the operation of transportation systems

while under Federal control, for the just compensation of their owners, and for other purposes,'' the tax imposed by this title shall be treated as levied by an Act in amendment of Title II of the Revenue Act of 1917.

Sec. 302. That the tax imposed by subdivision (a) of section 301 shall in no case be more than 30 per centum of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 80 per centum of the amount of the net income in excess of $20,000; the tax imposed by subdivision (b) of section 301 shall in no case be more than 20 per centum of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 40 per centum of the amount of the net income in excess of $20,000; and the above limitations shall apply to the taxes computed under subdivisions (a) and (b) of section 301, respectively, when used in subdivision (c) of that section. Nothing in this section shall be construed in such manner as to increase the tax imposed by section 301.

Sec. 303. That if part of the net income of a corporation is derived (1) from a trade or business (or a branch of a trade or business) in which the employment of capital is necessary, and (2) a part (constituting not less than 30 per centum of its total net income) is derived from a separate trade or business (or a distinctly separate branch of the trade or business) which if constituting the sole trade or business would bring it within the class of ''personal service corporations,'' then (under regulations prescribed by the Commissioner with the approval of the Secretary) the tax upon the first part of such net income shall be separately computed (allowing in such computation only the same proportionate part of the credits authorized in sections 311 and 312), and the tax upon the second part shall be the same percentage thereof as the tax so computed upon the first part is of such first part: *Provided,* That the tax upon such second part shall in no case be less than 20 per centum thereof, unless the tax upon the entire net income, if computed without benefit of this section, would constitute less than 20 per centum of such entire net income, in which event the tax shall be determined upon the entire net income, without reference to this section, as other taxes are determined under this title. The total tax computed under this section shall be subject to the limitations provided in section 302.

Sec. 304. (a) That the corporations enumerated in section 231 shall, to the extent that they are exempt from income tax under Title II, be exempt from taxation under this title.

(b) Any corporation whose net income for the taxable year is less than $3,000 shall be exempt from taxation under this title.

(c) In the case of any corporation engaged in the mining of gold, the portion of the net income derived from the mining of gold shall be exempt from the tax imposed by this title, and the tax on the remaining portion of the net income shall be the proportion of a tax computed without the benefit of this subdivision which such remaining portion of the net income bears to the entire net income.

Sec. 305. That if a tax is computed under this title for a period of less than twelve months, the specific exemption of $3,000, wherever referred to in this title, shall be reduced to an amount which is the same proportion of $3,000 as the number of months in the period is of twelve months.

Part III—Credits

Sec. 310. That as used in this title the term "prewar period" means the calendar years 1911, 1912, and 1913, or, if a corporation was not in existence during the whole of such period, then as many of such years during the whole of which the corporation was in existence.

Sec. 311. (a) That the war-profits credit shall consist of the sum of:

(1) A specific exemption of $3,000; and

(2) An amount equal to the average net income of the corporation for the prewar period, plus or minus, as the case may be, 10 per centum of the difference between the average invested capital for the prewar period and the invested capital for the taxable year. If the tax is computed for a period of less than twelve months such amount shall be reduced to the same proportion thereof as the number of months in the period is of twelve months.

(b) If the corporation had no net income for the prewar period, or if the amount computed under paragraph (2) of subdivision (a) is less than 10 per centum of its invested capital for the taxable year, then the war-profits credit shall be the sum of:

(1) A specific exemption of $3,000; and

(2) An amount equal to 10 per centum of the invested capital for the taxable year.

(c) If the corporation was not in existence during the whole of at least one calendar year during the prewar period, then, except as provided in subdivision (d), the war-profits credit shall be the sum of:

(1) A specific exemption of $3,000; and

(2) An amount equal to the same percentage of the invested capital of the taxpayer for the taxable year as the average percentage of net income to invested capital, for the prewar period, of corpora-

tions engaged in a trade or business of the same general class as that conducted by the taxpayer; but such amount shall in no case be less than 10 per centum of the invested capital of the taxpayer for the taxable year. Such average percentage shall be determined by the Commissioner on the basis of data contained in returns made under Title II of the Revenue Act of 1917, and the average known as the median shall be used. If such average percentage has not been determined and published at least 30 days prior to the time when the return of the taxpayer is due, then for purposes of such return 10 per centum shall be used in lieu thereof; but such average percentage when determined shall be used for the purposes of section 250 in determining the correct amount of the tax.

(d) The war-profits credit shall be determined in the manner provided in subdivision (b) instead of in the manner provided in subdivision (c), in the case of any corporation which was not in existence during the whole of at least one calendar year during the prewar period, if (1) a majority of its stock at any time during the taxable year is owned or controlled, directly or indirectly, by a corporation which was in existence during the whole of at least one calendar year during the prewar period, or if (2) 50 per centum or more of its gross income (as computed under section 233 for income tax purposes) consists of gains, profits, commissions, or other income, derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

(e) A foreign corporation shall not be entitled to a specific exemption of $3,000.

Sec. 312. That the excess-profits credit shall consist of a specific exemption of $3,000 plus an amount equal to 8 per centum of the invested capital for the taxable year.

A foreign corporation shall not be entitled to the specific exemption of $3,000.

Part IV—Net Income

Sec. 320. (a) That for the purpose of this title the net income of a corporation shall be ascertained and returned—

(1) For the calendar years 1911 and 1912 upon the same basis and in the same manner as provided in section 38 of the Act entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," approved August 5, 1909, except that taxes imposed by such section and paid by the corporation within the year shall be included;

(2) For the calendar year 1913 upon the same basis and in the same manner as provided in Section II of the Act entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," approved October 3, 1913, except that taxes imposed by section 38 of such Act of August 5, 1909, and paid by the corporation within the year shall be included, and except that the amounts received by it as dividends upon the stock or from the net earnings of other corporations subject to the tax imposed by Section II of such Act of October 3, 1913, shall be deducted; and

(3) For the taxable year upon the same basis and in the same manner as provided for income tax purposes in Title II of this Act.

(b) The average net income for the prewar period shall be determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the net income for such years, even though there may have been no net income for one or more of such years.

PART V—INVESTED CAPITAL

Sec. 325. (a) That as used in this title—

The term "intangible property" means patents, copyrights, secret processes and formulæ, good will, trade-marks, trade-brands, franchises, and other like property;

The term "tangible property" means stocks, bonds, notes, and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property;

The term "borrowed capital" means money or other property borrowed, whether represented by bonds, notes, open accounts, or otherwise;

The term "inadmissible assets" means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income, but where the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the interest derived from such assets is in effect included in the net income because of the limitation on the deduction of interest under paragraph (2) of subdivision (a) of section 234, a corresponding part of the capital invested in such assets shall not be deemed to be inadmissible assets;

The term "admissible assets" means all assets other than inadmissible assets, valued in accordance with the provisions of subdivision (a) of section 326, section 330, and section 331.

(b) For the purposes of this title, the par value of stock or shares shall, in the case of stock or shares issued at a nominal value or having no par value, be deemed to be the fair market value as of the date or dates of issue of such stock or shares.

Sec. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivision (b) and (c) of this section):

(1) Actual cash bona fide paid in for stock or shares;

(2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *Provided,* That the Commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257;

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: *Provided,* That in no case shall the total amount included under

paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

(b) As used in this title the term "invested capital" does not include borrowed capital.

(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall (except for the purpose of paragraph (2) of subdivision (a) of section (311) be the same fractional part of such average invested capital.

The average invested capital for the prewar period shall be determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the average invested capital for such years.

Sec. 327. That in the following cases the tax shall be determined as provided in section 328:

(a) Where the Commissioner is unable to determine the invested capital as provided in section 326;

(b) In the case of a foreign corporation;

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively;

(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, prof-

its, commissions, or other income, derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

Sec. 328. (a) In the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.

In cases in which the tax is to be computed under this section, if the tax as computed without the benefit of this section is less than 50 per centum of the net income of the taxpayer, the installments shall in the first instance be computed upon the basis of such tax; but if the tax so computed is 50 per centum or more of the net income, the installments shall in the first instance be computed upon the basis of a tax equal to 50 per centum of the net income. In any case, the actual ratio when ascertained shall be used in determining the correct amount of the tax. If the correct amount of the tax when determined exceeds 50 per centum of the net income, any excess of the correct installments over the amounts actually paid shall on notice and demand be paid together with interest at the rate of ½ of 1 per centum per month on such excess from the time the installment was due.

(c) The Commissioner shall keep a record of all cases in which the tax is determined in the manner prescribed in subdivision (a), containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, and the amount of invested capital as determined under such

subdivision. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257.

PART VI—REORGANIZATIONS

Sec. 330. That in the case of the reorganization, consolidation, or change of ownership after January 1, 1911, of a trade or business now carried on by a corporation, the corporation shall for the purposes of this title be deemed to have been in existence prior to that date, and the net income and invested capital of such predecessor trade or business for all or any part of the prewar period prior to the organization of the corporation now carrying on such trade or business shall be deemed to have been the net income and invested capital of such corporation.

If such predecessor trade or business was carried on by a partnership or individual the net income for the prewar period shall, under regulations prescribed by the Commissioner with the approval of the Secretary, be ascertained and returned as nearly as may be upon the same basis and in the same manner as provided for corportions in Title II, including a reasonable deduction for salary or compensation to each partner or the individual for personal services actually rendered.

In the case of the organization as a corporation before July 1, 1919 of any trade or business in which capital is a material income-producing factor and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1918, to the date of such reorganization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under Titles II and III; in which event the net income and invested capital of such trade or business shall be computed as if such corporation had been in existence on and after January 1, 1918, and the undistributed profits or earnings of such trade or business shall not be subject to the surtax imposed in section 211, but amounts distributed on or after January 1, 1918, from the earnings of such trade or business shall be taxed to the recipients as dividends, and all the provisions of Titles II and III relating to corporations shall so far as practicable apply to such trade or business: *Provided*, That this paragraph shall not apply to any trade or business the net income of which for the taxable year 1918 was less than 20 per centum of its invested capital for such year: *Provided*

further, That any taxpayer who takes advantage of this paragraph shall pay the tax imposed by section 1000 of this Act and by the first subdivision of section 407 of the Revenue Act of 1916, as if such taxpayer had been a corporation on and after January 1, 1918, with a capital stock having no par value.

If any asset of the trade or business in existence both during the taxable year and any prewar year is included in the invested capital for the taxable year but is not included in the invested capital for such prewar year, or is valued on a different basis in computing the invested capital for the taxable year and such prewar year, respectively, then under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary such readjustments shall be made as are necessary to place the computation of the invested capital for such prewar year on the basis employed in determining the invested capital for the taxable year.

Sec. 331. In the case of the reorganization, consolidation, or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917, if an interest or control in such trade or business or property of 50 per centum or more remains in the same persons, or any of them, then no asset transferred or received from the previous owner shall, for the purpose of determining invested capital, be allowed a greater value than would have been allowed under this title in computing the invested capital of such previous owner if such asset had not been so transferred or received: *Provided,* That if such previous owner was not a corporation, then the value of any asset so transferred or received shall be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost shall be made for any charge or expenditure deducted as expense or otherwise on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation.

Part VII—Miscellaneous

Sec. 335. (a) That if a corporation (other than a personal service corporation) makes return for a fiscal year beginning in 1917 and ending in 1918, the tax for the first taxable year under this title shall be the sum of: (1) the same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1917 which the portion of such period falling within the calendar year 1917 is of the entire period, and (2) the same proportion of a tax for the entire

period computed under this title at the rates specified in subdivision (a) of section 301 which the portion of such period falling within the calendar year 1918 is of the entire period. Any amount heretofore or hereafter paid on account of the tax imposed for such fiscal year by Title II of the Revenue Act of 1917 shall be credited toward the payment of the tax imposed for such fiscal year by this title, and if the amount so paid exceeds the amount of the tax imposed by this title, the excess shall be credited or refunded to the corporation in accordance with the provisions of section 252.

(b) If a corporation makes return for a fiscal year beginning in 1918 and ending in 1919, the tax for such fiscal year under this title shall be the sum of: (1) the same proportion of a tax for the entire period computed under subdivision (a) of section 301 which the portion of such period falling within the calendar year 1918 is of the entire period, and (2) the same proportion of a tax for the entire period computed under subdivision (b) or (c) of section 301 which the portion of such period falling within the calendar year 1919 is of the entire period.

(c) If a partnership or a personal service corporation makes return for a fiscal year beginning in 1917 and ending in 1918, it shall pay the same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1917 which the portion of such period falling within the calendar year 1917 is of the entire period.

Any tax paid by a partnership or personal service corporation for any period beginning on or after January 1, 1918, shall be immediately refunded to the partnership or corporation as a tax erroneously or illegally collected.

Sec. 336. That every corporation, not exempt under section 304, shall make a return for the purposes of this title. Such returns shall be made, and the taxes imposed by this title shall be paid, at the same times and places, in the same manner, and subject to the same conditions, as is provided in the case of returns and payment of income tax by corporations for the purposes of Title II, and all the provisions of that title not inapplicable, including penalties, are hereby made applicable to the taxes imposed by this title.

Sec. 337. That in the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this title attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest.

TITLE X—SPECIAL TAXES

[CAPITAL STOCK TAX]

Sec. 1000. (a) That on and after July 1, 1918, in lieu of the tax imposed by the first subdivision of section 407 of the Revenue Act of 1916—

(1) Every domestic corporation shall pay annually a special excise tax with respect to carrying on or doing business, equivalent to $1 for each $1,000 of so much of the fair average value of its capital stock for the preceding year ending June 30 as is in excess of $5,000. In estimating the value of capital stock the surplus and undivided profits shall be included;

(2) Every foreign corporation shall pay annually a special excise tax with respect to carrying on or doing business in the United States, equivalent to $1 for each $1,000 of the average amount of capital employed in the transaction of its business in the United States during the preceding year ending June thirtieth.

(b) In computing the tax in the case of insurance companies such deposits and reserve funds as they are required by law or contract to maintain or hold for the protection of or payment to or apportionment among policyholders shall not be included.

(c) The taxes imposed by this section shall not apply in any year to any corporation which was not engaged in business (or in the case of a foreign corporation not engaged in business in the United States) during the preceding year ending June 30, nor to any corporation enumerated in section 231. The taxes imposed by this section shall apply to mutual insurance companies, and in the case of every such domestic company the tax shall be equivalent to $1 for each $1,000 of the excess over $5,000 of the sum of its surplus or contingent reserves maintained for the general use of the business and any reserves the net additions to which are included in net income under the provisions of Title II, as of the close of the preceding accounting period used by such company for purposes of making its income tax return: *Provided,* That in the case of a foreign mutual insurance company the tax shall be equivalent to $1 for each $1,000 of the same proportion of the sum of such surplus and reserves, which the reserve fund upon business transacted within the United States is of the total reserve upon all business transacted, as of the close of the preceding accounting period used by such company for purposes of making its income tax return.

(d) Section 257 shall apply to all returns filed with the Commissioner for purposes of the tax imposed by this section.

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TITLE XI—STAMP TAXES

Sec. 1100. That on and after April 1, 1919, there shall be levied, collected, and paid, for and in respect of the several bonds, debentures, or certificates of stock and of indebtedness, and other documents, instruments, matters, and things mentioned and described in Schedule A of this title, or for or in respect of the vellum, parchment, or paper upon which such instruments, matters, or things, or any of them, are written or printed, by any person who makes, signs, issues, sells, removes, consigns, or ships the same, or for whose use or benefit the same are made, signed, issued, sold, removed, consigned, or shipped, the several taxes specified in such schedule. The taxes imposed by this section shall, in the case of any article upon which a corresponding stamp tax is now imposed by law, be in lieu of such tax.

Sec. 1101. That there shall not be taxed under this title any bond, note, or other instrument, issued by the United States, or by any foreign Government, or by any State, Territory, or the District of Columbia, or local subdivision thereof, or municipal or other corporation exercising the taxing power; or any bond of indemnity required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States; or stocks and bonds issued by cooperative building and loan associations which are organized and operated exclusively for the benefit of their members and make loans only to their shareholders, or by mutual ditch or irrigating companies.

Sec. 1102. That whoever—

(a) Makes, signs, issues, or accepts, or causes to be made, signed, issued, or accepted, any instrument, document, or paper of any kind or description whatsoever without the full amount of tax thereon being duly paid;

(b) Consigns or ships, or causes to be consigned or shipped, by parcel post any parcel, package, or article without the full amount of tax being duly paid;

(c) Manufactures or imports and sells, or offers for sale, or causes to be manufactured or imported and sold, or offered for sale, any playing cards, package, or other article without the full amount of tax being duly paid;

(d) Makes use of any adhesive stamp to denote any tax imposed

by this title without canceling or obliterating such stamp as prescribed in section 1104;

Is guilty of a misdemeanor and upon conviction thereof shall pay a fine of not more than $100 for each offense.

Sec. 1103. That whoever—

(a) Fraudulently cuts, tears, or removes from any vellum, parchment, paper, instrument, writing, package, or article, upon which any tax is imposed by this title, any adhesive stamp or the impression of any stamp, die, plate, or other article provided, made, or used in pursuance of this title;

(b) Fraudulently uses, joins, fixes, or places to, with, or upon any vellum, parchment, paper, instrument, writing, package, or article, upon which any tax is imposed by this title, (1) any adhesive stamp, or the impression of any stamp, die, plate, or other article, which has been cut, torn, or removed from any other vellum, parchment, paper, instrument, writing, package, or article, upon which any tax is imposed by this title; or (2) any adhesive stamp or the impression of any stamp, die, plate, or other article of insufficient value; or (3) any forged or counterfeit stamp, or the impression of any forged or counterfeited stamp, die, plate, or other article;

(c) Willfully removes, or alters the cancellation, or defacing marks of, or otherwise prepares, any adhesive stamp, with intent to use, or cause the same to be used, after it has been already used, or knowingly or willfully buys, sells, offers for sale, or gives away, any such washed or restored stamp to any person for use, or knowingly uses the same;

(d) Knowingly and without lawful excuse (the burden of proof of such excuse being on the accused) has in possession any washed, restored, or altered stamp, which has been removed from any vellum, parchment, paper, instrument, writing, package, or article;

Is guilty of a misdemeanor, and upon conviction shall be punished by a fine of not more than $1,000, or by imprisonment for not more than five years, or both, and any such reused, canceled, or counterfeit stamp and the vellum, parchment, document, paper, package, or article upon which it is placed or impressed shall be forfeited to the United States.

Sec. 1104. That whenever an adhesive stamp is used for denoting any tax imposed by this title, except as hereinafter provided, the person using or affixing the same shall write or stamp or cause to be written or stamped thereupon the initials of his or its name and the date upon which the same is attached or used, so that the same may not again be used: *Provided,* That the Commissioner may prescribe

such other method for the cancellation of such stamps as he may deem expedient.

Sec. 1105. (a) That the Commissioner shall cause to be prepared and distributed for the payment of the taxes prescribed in this title suitable stamps denoting the tax on the document, articles, or thing to which the same may be affixed, and shall prescribe such method for the affixing of said stamps in substitution for or in addition to the method provided in this title, as he may deem expedient.

(b) The Commissioner, with the approval of the Secretary, is authorized to procure any of the stamps provided for in this title by contract whenever such stamps can not be speedily prepared by the Bureau of Engraving and Printing; but this authority shall expire on January 1, 1920, except as to imprinted stamps furnished under contract, authorized by the Commissioner.

(c) All internal-revenue laws relating to the assessment and collection of taxes are hereby extended to and made a part of this title, so far as applicable, for the purpose of collecting stamp taxes omitted through mistake or fraud from any instrument, document, paper, writing, parcel, package, or article named herein.

Sec. 1106. That the Commissioner shall furnish to the Postmaster General without prepayment a suitable quantity of adhesive stamps to be distributed to and kept on sale by the various postmasters in the United States. The Postmaster General may require each such postmaster to give additional or increased bond as postmaster for the value of the stamps so furnished, and each such postmaster shall deposit the receipts from the sale of such stamps to the credit of and render accounts to the Postmaster General at such times and in such form as he may by regulations prescribe. The Postmaster General shall at least once monthly transfer all collections from this source to the Treasury as internal-revenue collections.

Sec. 1107. That the collectors of the several districts shall furnish without prepayment to any assistant treasurer or designated depositary of the United States located in their respective collection districts a suitable quantity of adhesive stamps for sale. In such cases the collector may require a bond, with sufficient sureties, to an amount equal to the value of the adhesive stamps so furnished, conditioned for the faithful return, whenever so required, of all quantities or amounts undisposed of, and for the payment monthly of all quantities or amounts sold or not remaining on hand. The Secretary may from time to time make such regulations as he may find necessary to insure the safekeeping or prevent the illegal use of all such adhesive stamps.

Schedule A—Stamp Taxes

1. Bonds of indebtedness: On all bonds, debentures, or certificates of indebtedness issued by any person, and all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities, on each $100 of face value or fraction thereor, 5 cents: *Provided*, That every renewal of the foregoing shall be taxed as a new issue: *Provided further*, That when a bond conditioned for the repayment or payment of money is given in a penal sum greater than the debt secured, the tax shall be based upon the amount secured.

2. Bonds, indemnity and surety: On all bonds executed for indemnifying any person who shall have become bound or engaged as surety, and on all bonds executed for the due execution or performance of any contract, obligation, or requirement, or the duties of any office or position, and to account for money received by virtue thereof, and on all policies of guaranty and fidelity insurance, including policies guaranteeing titles to real estate and mortgage guarantee policies, and on all other bonds of any description, made, issued, or executed, not otherwise provided for in this schedule, except such as may be required in legal proceedings, 50 cents: *Provided*, That where a premium is charged for the issuance, execution, renewal or continuance of such bond the tax shall be 1 cent on each dollar or fractional part thereof the premium charged: *Provided further*, That policies of reinsurance shall be exempt from the tax imposed by this subdivision.

3. Capital stock, issued: On each original issue, whether on organization or reorganization, of certificates of stock, or of profits, or of interest in property or accumulations, by any corporation, on each $100 of face value or fraction thereof, 5 cents: *Provided*, That where a certificate is issued without face value, the tax shall be 5 cents per share, unless the actual value is in excess of $100 per share, in which case the tax shall be 5 cents on each $100 of actual value or fraction thereof.

The stamps representing the tax imposed by this subdivision shall be attached to the stock books and not to the certificates issued.

4. Capital stock, sales or transfers: On all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to shares or certificates of stock or of profits or of interest in property or accumulations in any corporation, or to rights to subscribe for or to receive such shares or certificates, whether made upon or shown by the books of the corporation, or by any assignment in blank, or by

any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock, interest, or rights, or not, on each $100 of face value or fraction thereof, 2 cents, and where such shares are without par or face value, the tax shall be 2 cents on the transfer or sale or agreement to sell on each share, unless the actual value thereof is in excess of $100 per share, in which case the tax shall be 2 cents on each $100 of actual value or fraction thereof: *Provided*, That it is not intended by this title to impose a tax upon an agreement evidencing a deposit of certificates as collateral security for money loaned thereon, which certificates are not actually sold, nor upon the delivery or transfer for such purpose of certificates so deposited: *Provided further*, That the tax shall not be imposed upon deliveries or transfers to a broker for sale, nor upon deliveries or transfers by a broker to a customer for whom and upon whose order he has purchased same, but such deliveries or transfers shall be accompanied by a certificate setting forth the facts: *Provided further*, That in case of sale where the evidence of transfer is shown only by the books of the corporation the stamp shall be placed upon such books; and where the change of ownership is by transfer of the certificate the stamp shall be placed upon the certificate; and in cases of an agreement to sell or where the transfer is by delivery of the certificate assigned in blank there shall be made and delivered by the seller to the buyer a bill or memorandum of such sale, to which the stamp shall be affixed; and every bill or memorandum of sale or agreement to sell before mentioned shall show the date thereof, the name of the seller, the amount of the sale and the matter or thing to which it refers. Any person liable to pay the tax as herein provided, or anyone who acts in the matter as agent or broker for such person, who makes any such sale, or who in pursuance of any such sale delivers any certificate or evidence of the sale of any stock, interest or right, or bill or memorandum thereof, as herein required, without having the proper stamps affixed thereto with intent to evade the foregoing provisions, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall pay a fine of not exceeding $1,000, or be imprisoned not more than six months, or both.

5. Produce, sales of, on exchange: Upon each sale, agreement of sale, or agreement to sell (not including so-called transferred or scratch sales), any products or merchandise at, or under the rules or usages of, any exchange, or board of trade, or other similar place, for future delivery, for each $100 in value of the merchandise covered by said sale or agreement of sale or agreement to sell, 2 cents, and for

each additional $100 or fractional part thereof in excess of $100, 2 cents: *Provided,* That on every sale or agreement of sale or agreement to sell as aforesaid there shall be made and delivered by the seller to the buyer a bill, memorandum, agreement, or other evidence of such sale, agreement of sale, or agreement to sell, to which there shall be affixed a lawful stamp or stamps in value equal to the amount of the tax on such sale: *Provided further,* That sellers of commodities described herein, having paid the tax provided by this subdivision, may transfer such contracts to a clearing-house corporation or association, and such transfer shall not be deemed to be a sale, or agreement of sale, or an agreement to sell within the provisions of this Act, provided that such transfer shall not vest any beneficial interest in such clearing-house association but shall be made for the sole purpose of enabling such clearing-house association to adjust and balance the accounts of the members of such clearing-house association on their several contracts. Every such bill, memorandum, or other evidence of sale or agreement to sell shall show the date thereof, the name of the seller, the amount of the sale, and the matter or thing to which it refers; and any person liable to pay the tax as herein provided, or anyone who acts in the matter as agent or broker for such person, who makes any such sale or agreement of sale, or agreement to sell, or who, in pursuance of any such sale, agreement of sale, or agreement to sell, delivers any such products or merchandise without a bill, memorandum, or other evidence thereof as herein required, or who delivers such bill, memorandum, or other evidence of sale, or agreement to sell, without having the proper stamps affixed thereto, with intent to evade the foregoing provisions, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall pay a fine of not exceeding $1,000 or be imprisoned not more than six months, or both.

No bill, memorandum, agreement, or other evidence of such sale, or agreement of sale, or agreement to sell, in case of cash sales of products or merchandise for immediate or prompt delivery which in good faith are actually intended to be delivered shall be subject to this tax.

6. Drafts or checks (payable otherwise than at sight or on demand) upon their acceptance or delivery within the United States whichever is prior, promissory notes, except bank notes issued for circulation, and for each renewal of the same, for a sum not exceeding $100, 2 cents; and for each additional $100, or fractional part thereof, 2 cents.

This subdivision shall not apply to a promissory note secured by

the pledge of bonds or obligations of the United States issued after April 24, 1917, or secured by the pledge of a promissory note which itself is secured by the pledge of such bonds or obligations: *Provided*, That in either case the par value of such bonds or obligations shall be not less than the amount of such note.

7. Conveyances: Deed, instrument, or writing, whereby any lands, tenements, or other realty sold shall be granted, assigned, transferred, or otherwise conveyed to, or vested in, the purchaser or purchasers, or any other person or persons, by his, her, or their direction, when the consideration or value of the interest or property conveyed, exclusive of the value of any lien or encumbrance remaining thereon at the time of sale, exceeds $100 and does not exceed $500, 50 cents; and for each additional $500 or fractional part thereof, 50 cents. This subdivision shall not apply to any instrument or writing given to secure a debt.

8. Entry of any goods, wares, or merchandise at any customhouse, either for consumption or warehousing, not exceeding $100 in value, 25 cents; exceeding $100 and not exceeding $500 in value, 50 cents; exceeding $500 in value, $1.

9. Entry for the withdrawal of any goods or merchandise from customs bonded warehouse, 50 cents.

10. Passage ticket, one way or round trip, for each passenger, sold or issued in the United States for passage by any vessel to a port or place not in the United States, Canada, or Mexico, if costing not exceeding $30, $1; costing more than $30 and not exceeding $60, $3; costing more than $60, $5. This subdivision shall not apply to passage tickets costing $10 or less.

11. Proxy for voting at any election for officers, or meeting for the transaction of business, of any corporation, except religious, educational, charitable, fraternal, or literary societies, or public cemeteries, 10 cents.

12. Power of attorney granting authority to do or perform some act for or in behalf of the grantor, which authority is not otherwise vested in the grantee, 25 cents. This subdivision shall not apply to any papers necessary to be used for the collection of claims from the United States or from any State for pensions, back pay, bounty, or for property lost in the military or naval service, or to powers of attorney required in bankruptcy cases.

13. Playing cards: Upon every pack of playing cards containing not more than fifty-four cards, manufactured or imported, and sold, or removed for consumption or sale, a tax of 8 cents per pack.

14. Parcel-post packages: Upon every parcel or package trans-

ported from one point in the United States to another by parcel post on which the postage amounts to 25 cents or more, a tax of 1 cent for each 25 cents or fractional part thereof charged for such transportation, to be paid by the consignor.

No such parcel or package shall be transported until a stamp or stamps representing the tax due shall have been affixed thereto.

15. On each policy of insurance, or certificate, binder, covering note, memorandum, cablegram, letter, or other instrument by whatever name called whereby insurance is made or renewed upon property within the United States (including rents and profits) against peril by sea or on inland waters or in transit on land (including transshipments and storage at termini or way points) or by fire, lightning, tornado, wind-storm, bombardment, invasion, insurrection or riot, issued to or for or in the name of a domestic corporation or partnership or an individual resident of the United States by any foreign corporation or partnership or any individual not a resident of the United States, when such policy or other instrument is not signed or countersigned by an officer or agent of the insurer in a State, Territory, or district of the United States within which such insurer is authorized to do business, a tax of 3 cents on each dollar, or fractional part thereof of the premium charged: *Provided*, That policies of re-insurance shall be exempt from the tax imposed by this subdivision.

Any person to or for whom or in whose name any such policy or other instrument is issued, or any solicitor or broker acting for or on behalf of such person in the procurement of any such policy or other instrument, shall affix the proper stamps to such policy or other instrument, and for failure to affix such stamps with intent to evade the tax shall, in addition to other penalties provided therefor, pay a fine of double the amount of the tax.

TITLE XII—TAX ON EMPLOYMENT OF CHILD LABOR

Sec. 1200. That every person (other than a bona fide boys' or girls' canning club recognized by the Agricultural Department of a State and of the United States) operating (a) any mine or quarry situated in the United States in which children under the age of sixteen years have been employed or permitted to work during any portion of the taxable year; or (b) any mill, cannery, workshop, factory, or manufacturing establishment situated in the United States in which children under the age of fourteen years have been employed or permitted to work, or children between the ages of fourteen and sixteen have

been employed or permitted to work more than eight hours in any day or more than six days in any week, or after the hour of seven o'clock post meridian, or before the hour of six o'clock ante meridian, during any portion of the taxable year, shall pay for each taxable year, in additon to all other taxes imposed by law, an excise tax equivalent to 10 per centum of the entire net profits received or accrued for such year from the sale or disposition of the product of such mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment.

Sec. 1201. That in computing net profits under the provisions of this title, for the purpose of the tax there shall be allowed as deductions from the gross amount received or accrued for the taxable year from the sale or disposition of such products manufactured within the United States the following items:

(a) The cost of raw materials entering into the production;

(b) Running expenses, including rentals, cost of repairs, and maintenance, heat, power, insurance, management, and a reasonable allowance for salaries or other compensations for personal services actually rendered, and for depreciation;

(c) Interest paid within the taxable year on debts or loans contracted to meet the needs of the business, and the proceeds of which have been actually used to meet such needs;

(d) Taxes of all kinds paid during the taxable year with respect to the business or property relating to the production; and

(e) Losses actually sustained within the taxable year in connection with the business of producing such products, including losses from fire, flood, storm, or other casualties, and not compensated for by insurance or otherwise.

Sec. 1202. That if any such person during any taxable year or part thereof, whether under any agreement, arrangement, or understanding or otherwise, sells or disposes of any product of such mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment at less than the fair market price obtainable therefor either (a) in such manner as directly or indirectly to benefit such person or any person directly or indirectly interested in the business of such person; or (b) with intent to cause such benefit; the gross amount received or accrued for such year or part thereof from the sale or disposition of such product shall be taken to be the amount which would have been received or accrued from the sale or disposition of such product if sold at the fair market price.

Sec. 1203. (a) That no person subject to the provisions of this title shall be liable for the tax herein imposed if the only employ-

ment or permission to work which but for this section would subject him to the tax, has been of a child as to whom such person has in good faith procured at the time of employing such child or permitting him to work, and has since in good faith relied upon and kept on file a certificate, issued in such form, under such conditions and by such persons as may be prescribed by a board consisting of the Secretary, the Commissioner, and the Secretary of Labor, showing the child to be of such age as not to subject such person to the tax imposed by this title. Any person who knowingly makes a false statement or presents false evidence in or in relation to any such certificate or application therefor shall be punished by a fine of not less than $100, nor more than $1,000, or by imprisonment for not more than three months, or by both such fine and imprisonment, in the discretion of the court.

In any State designated by such board an employment certificate or other similar paper as to the age of the child, issued under the laws of that State, and not inconsistent with the provisions of this title, shall have the same force and effect as a certificate herein provided for.

(b) The tax imposed by this title shall not be imposed in the case of any person who proves to the satisfaction of the Secretary that the only employment or permission to work which but for this section would subject him to the tax, has been of a child employed or permitted to work under a mistake of fact as to the age of such child, and without intention to evade the tax.

Sec. 1204. That on or before the first day of the third month following the close of each taxable year, a true and accurate return under oath shall be made by each person subject to the provisions of this title to the collector for the district in which such person has his principal office or place of business, in such form as the Commissioner, with the approval of the Secretary, shall prescribe, setting forth specifically the gross amount of income received or accrued during such year from the sale or disposition of the product of any mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment, in which children have been employed subjecting him to the tax imposed by this title, and from the total thereof deducting the aggregate items of allowance authorized by this title, and such other particulars as to the gross receipts and items of allowance as the Commissioner, with the approval of the Secretary may require.

Sec. 1205. That all such returns shall be transmitted forthwith by the collector to the Commissioner, who shall, as soon as practi-

cable, assess the tax found due and notify the person making such return of the amount of tax for which such person is liable, and such person shall pay the tax to the collector on or before thirty days from the date of such notice.

Sec. 1206. That for the purposes of this Act the Commissioner, or any other person duly authorized by him, shall have authority to enter and inspect at any time any mine, quarry, mill, cannery, workshop, factory, or manufacturing establishment. The Secretary of Labor, or any person duly authorized by him, shall, for the purpose of complying with a request of the Commissioner to make such an inspection, have like authority, and shall make report to the Commissioner of inspections made under such authority in such form as may be prescribed by the Commissioner with the approval of the Secretary of the Treasury.

Any person who refuses or obstructs entry or inspection authorized by this section shall be punished by a fine of not more than $1,000, or by imprisonment for not more than one year, or both such fine and imprisonment.

Sec. 1207. That as used in this title the term "taxable year" shall have the same meaning as provided for the purposes of income tax in section 200. The first taxable year for the purposes of this title shall be the period between sixty days after the passage of this Act and December 31, 1919, both inclusive, or such portion of such period as is included within the fiscal year (as defined in section 200) of the taxpayer.

TITLE XIII—GENERAL ADMINISTRATIVE PROVISIONS[1]

Section 1301. (d) (1) There is hereby created a board to be known as the "Advisory Tax Board," hereinafter called the Board, and to be composed of not to exceed six members to be appointed by the Commissioner with the approval of the Secretary. The Board shall cease to exist at the expiration of two years after the passage of this Act, or at such earlier time as the Commissioner with the approval of the Secretary may designate.

Vacancies in the membership of the Board shall be filled in the same manner as an original appointment. Any member shall be subject to removal by the Commissioner with the approval of the Secretary. The Commissioner with the approval of the Secretary

[1] Parts of this title are omitted, being general provisions of no direct application to the taxes treated in this book.

shall designate the chairman of the Board. Each member shall receive an annual salary of $9,000, payable monthly, together with actual necessary expenses when absent from the District of Columbia on official business.

(2) The Commissioner may, and on the request of any taxpayer directly interested shall, submit to the Board any question relating to the interpretation or administration of the income, war-profits or excess-profits tax laws, and the Board shall report its findings and recommendations to the Commissioner.

(3) The Board shall have its office in the Bureau of Internal Revenue in the District of Columbia. The expenses and salaries of members of the Board shall be audited, allowed, and paid out of appropriations for collecting internal revenue, in the same manner as expenses and salaries of employees of the Bureau of Internal Revenue are audited, allowed, and paid.

(4) The Board shall have the power to summon witnesses, take testimony, administer oaths, and to require any person to produce books, papers, documents, or other data relating to any matter under investigation by the Board. Any member of the Board may sign subpoenas and members and employees of the Bureau of Internal Revenue designated to assist the Board, when authorized by the Board, may administer oaths, examine witnesses, take testimony and receive evidence.

Sec. 1305. That all administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this Act, and every person liable to any tax imposed by this Act, or for the collection thereof, shall keep such records and render, under oath, such statements and returns, and shall comply with such regulations as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

Whenever in the judgment of the Commissioner necessary he may require any person, by notice served upon him, to make a return or such statements as he deems sufficient to show whether or not such person is liable to tax.

The Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is hereby authorized, by any revenue agent or inspector designated by him for that purpose, to examine any books, papers, records or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of

such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons.

Sec. 1307. That in all cases where the method of collecting the tax imposed by this Act is not specifically provided in this Act, the tax shall be collected in such manner as the Commissioner, with the approval of the Secretary, may prescribe. All administrative and penalty provisions of Title XI of this Act, in so far as applicable, shall apply to the collection of any tax which the Commissioner determines or prescribes shall be paid by stamp.

Sec. 1308. (a) That any person required under Titles V, VI, VII, VIII, IX, X, or XII, to pay, or to collect, account for and pay over any tax, or required by law or regulations made under authority thereof to make a return or supply any information for the purposes of the computation, assessment or collection of any such tax, who fails to pay, collect, or truly account for and pay over any such tax, make any such return or supply any such information at the time or times required by law or regulation shall in addition to other penalties provided by law be subject to a penalty of not more than $1,000.

(b) Any person who willfully refuses to pay, collect, or truly account for and pay over any such tax, make such return or supply such information at the time or times required by law or regulation, or who willfully attempts in any manner to evade such tax shall be guilty of a misdemeanor and in addition to other penalties provided by law shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

(c) Any person who willfully refuses to pay, collect, or truly account for and pay over any such tax shall in addition to other penalties provided by law be liable to a penalty of the amount of the tax evaded, or not paid, collected, or accounted for and paid over, to be assessed and collected in the same manner as taxes are assessed and collected: *Provided, however,* That no penalty shall be assessed under this subdivision for any offense for which a penalty may be assessed under authority of section 3176 of the Revised Statutes, as amended, or of section 605 or 620 of this Act, or for any offense for which a penalty has been recovered under section 3256 of the Revised Statutes.

(d) The term "person" as used in this section includes an officer or employee of a corporation or a member or employee of a

partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

Sec. 1309. That the Commissioner, with the approval of the Secretary, is hereby authorized to make all needful rules and regulations for the enforcement of the provisions of this Act.

The Commissioner with such approval may by regulation provide that any return required by Titles V, VI, VII, VIII, IX, or X to be under oath may, if the amount of the tax covered thereby is not in excess of $10, be signed or acknowledged before two witnesses instead of under oath.

Sec. 1313. That in the payment of any tax under this Act not payable by stamp a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent.

Sec. 1314. That collectors may receive, at par with an adjustment for accrued interest, certificates of indebtedness issued by the United States and uncertified checks in payment of income, war-profits and excess-profits taxes and any other taxes payable other than by stamp, during such time and under such regulations as the Commissioner, with the approval of the Secretary, shall prescribe; but if a check so received is not paid by the bank on which it is drawn the person by whom such check has been tendered shall remain liable for the payment of the tax and for all legal penalties and additions the same as if such check had not been tendered.

Sec. 1316. (a) That section 3220 of the Revised Statutes is hereby amended to read as follows:

"Sec. 3220. The Commissioner of Internal Revenue, subject to regulations prescribed by the Secretary of the Treasury, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected; also to repay to any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal revenue taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any assessor, assistant assessor, collector, deputy collector, agent, or inspector, in any suit brought against him by reason of anything done in the due performance of his official duty, and shall make report to Congress at the beginning of each regular session of Congress of all transactions under this section."

(b) Section 3225 of the Revised Statutes of the United States is hereby amended to read as follows:

"Sec. 3225. When a second assessment is made in case of any list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, such assessment shall not be remitted, nor shall taxes collected under such assessment be refunded, or paid back, or recovered by any suit, unless it is proved that such list, statement, or return was not willfully false or fraudulent and did not contain any willful understatement or undervaluation."

(c) That the paragraph of section 3689 of the Revised Statutes, as amended, reading as follows: "Refunding taxes illegally collected (internal revenue): To refund and pay back duties erroneously or illegally assessed or collected under the internal-revenue laws," is repealed from and after June 30, 1920; and the Secretary of the Treasury shall submit for the fiscal year 1921, and annually thereafter, an estimate of appropriations to refund and pay back duties or taxes erroneously or illegally assessed or collected under the internal-revenue laws, and to pay judgments, including interest and costs, rendered for taxes or penalties erroneously or illegally assessed or collected under the internal-revenue laws.

Sec. 1317. That sections 3164, 3165, 3167, 3172, 3173, and 3176 of the Revised Statutes as amended are hereby amended to read as follows:

"Sec. 3164. It shall be the duty of every collector of internal revenue having knowledge of any willful violation of any law of the United States relating to the revenue, within thirty days after coming into possession of such knowledge, to file with the district attorney of the district in which any fine, penalty, or forfeiture may be incurred, a statement of all the facts and circumstances of the case within his knowledge, together with the names of the witnesses, setting forth the provisions of law believed to be so violated on which reliance may be had for condemnation or conviction.

"Sec. 3165. Every collector, deputy collector, internal-revenue agent, and internal-revenue officer assigned to duty under an internal-revenue agent, is authorized to administer oaths and to take evidence touching any part of the administration of the internal-revenue laws with which he is charged, or where such oaths and evidence are authorized by law or regulation authorized by law to be taken.

"Sec. 3167. It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States

to divulge or to make known in any manner whatever not provided by law to any person the operations, style of work, or apparatus of any manufacturer or producer visited by him in the discharge of his official duties, or the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return; and any offense against the foregoing provision shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States he shall be dismissed from office or discharged from employment.

"Sec. 3172. Every collector shall, from time to time, cause his deputies to proceed through every part of his district and inquire after and concerning all persons therein who are liable to pay any internal-revenue tax, and all persons owning or having the care and management of any objects liable to pay any tax, and to make a list of such persons and enumerate said objects.

"Sec. 3173. It shall be the duty of any person, partnership, firm, association, or corporation, made liable to any duty, special tax, or other tax imposed by law, when not otherwise provided for, (1) in case of a special tax, on or before the thirty-first day of July in each year, and (2) in other cases before the day on which the taxes accrue, to make a list or return, verified by oath, to the collector or a deputy collector of the district where located, of the articles or objects, including the quantity of goods, wares, and merchandise, made or sold and charged with a tax, the several rates and aggregate amount, according to the forms and regulations to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, for which such person, partnership, firm, association, or corporation is liable: *Provided*, That if any person liable to pay any duty or tax, or owning, possessing, or having the care or management of property, goods, wares, and merchandise, article or objects liable to pay any duty, tax, or license, shall fail to make and exhibit a list or return required by law, but shall consent to disclose the particulars of any and all the property, goods, wares, and merchandise, articles, and objects liable to pay

any duty or tax, or any business or occupation liable to pay any tax as aforesaid, then, and in that case, it shall be the duty of the collector or deputy collector to make such list or return, which, being distinctly read, consented to, and signed and verified by oath by the person so owning, possessing, or having the care and management as aforesaid, may be received as the list of such person: *Provided further*, That in case no annual list or return has been rendered by such person to the collector or deputy collector as required by law, and the person shall be absent from his or her residence or place of business at the time the collector or a deputy collector shall call for the annual list or return, it shall be the duty of such collector or deputy collector to leave at such place of residence or business, with some one of suitable age and discretion, if such be present, otherwise to deposit in the nearest post office, a note or memorandum addressed to such person, requiring him or her to render to such collector or deputy collector the list or return required by law within ten days from the date of such note or memorandum, verified by oath. And if any person, on being notified or required as aforesaid, shall refuse or neglect to render such list or return within the time required as aforesaid, or whenever any person who is required to deliver a monthly or other return of objects subject to tax fails to do so at the time required, or delivers any return which, in the opinion of the collector, is erroneous, false, or fraudulent, or contains any undervaluation or understatement, or refuses to allow any regularly authorized Government officer to examine the books of such person, firm, or corporation, it shall be lawful for the collector to summon such person, or any other person having possession, custody, or care of books of account containing entries relating to the business of such person or any other person he may deem proper, to appear before him and produce such books at a time and place named in the summons, and to give testimony or answer interrogatories, under oath, respecting any objects or income liable to tax or the returns thereof. The collector may summon any person residing or found within the State or Territory in which his district lies; and when the person intended to be summoned does not reside and can not be found within such State or Territory, he may enter any collection district where such person may be found and there make the examination herein authorized. And to this end he may there exercise all the authority which he might lawfully exercise in the district for which he was commissioned: *Provided*, That 'person,' as used in this section, shall be construed to include any corpora-

tion, joint-stock company or association, or insurance company when such construction is necessary to carry out its provisions.

"Sec. 3176. If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes.

"If the failure to file a return or list is due to sickness or absence, the collector may allow such further time, not exceeding thirty days, for making and filing the return or list as he deems proper.

"The Commissioner of Internal Revenue shall determine and assess all taxes, other than stamp taxes, as to which returns or lists are so made under the provisions of this section. In case of any failure to make and file a return or list within the time prescribed by law, or prescribed by the Commissioner of Internal Revenue or the collector in pursuance of law, the Commissioner of Internal Revenue shall add to the tax 25 per centum of its amount, except that when a return is filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax. In case a false or fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax 50 per centum of its amount.

"The amount so added to any tax shall be collected at the same time and in the same manner and as part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax."

Sec. 1318. That if any person is summoned under this Act to appear, to testify, or to produce books, papers or other data, the district court of the United States for the district in which such person resides shall have jurisdiction by appropriate process to

compel such attendance, testimony, or production of books, papers, or other data.

The district courts of the United States at the instance of the United States are hereby invested with such jurisdiction to make and issue, both in actions at law and suits in equity, writs and orders of injunction, and of ne exeat republica, orders appointing receivers, and such other orders and process, and to render such judgments and decrees, granting in proper cases both legal and equitable relief together, as may be necessary or appropriate for the enforcement of the provisions of this Act. The remedies hereby provided are in addition to and not exclusive of any and all other remedies of the United States in such courts or otherwise to enforce such provisions.

Sec. 1319. That whoever in connection with the sale or lease, or offer for sale or lease, of any article, or for the purpose of making such sale or lease, makes any statement, written or oral, (1) intended or calculated to lead any person to believe that any part of the price at which such article is sold or leased, or offered for sale or lease, consists of a tax imposed under the authority of the United States, or (2) ascribing a particular part of such price to a tax imposed under the authority of the United States, knowing that such statement is false or that the tax is not so great as the portion of such price ascribed to such tax, shall be guilty of a misdemeanor and upon conviction thereof shall be punished by a fine of not more than $1,000 or by imprisonment not exceeding one year, or both.

Sec. 1320. That wherever by the laws of the United States or regulations made pursuant thereto, any person is required to furnish any recognizance, stipulation, bond, guaranty, or undertaking hereinafter called "penal bond", with surety or sureties, such person may, in lieu of such surety or sureties, deposit as security with the official having authority to approve such penal bond, United States Liberty bonds or other bonds of the United States in a sum equal at their par value to the amount of such penal bond required to be furnished, together with an agreement authorizing such official to collect or sell such bonds so deposited in case of any default in the performance of any of the conditions or stipulations of such penal bond. The acceptance of such United States bonds in lieu of surety or sureties required by law shall have the same force and effect as individual or corporate sureties, or certified checks, bank drafts, post-office money orders, or cash, for the penalty or amount of such penal bond. The bonds deposited hereunder, and such other United States bonds as may be substituted therefor from time to time as such security,

may be deposited with the Treasurer, or an Assistant Treasurer of the United States, a Government depository, Federal Reserve bank, or member bank, which shall issue receipt therefor, describing such bonds so deposited. As soon as security for the performance of such penal bond is no longer necessary, such bonds so deposited, shall be returned to the depositor: *Provided*, That in case a person or persons supplying a contractor with labor or material as provided by the Act of Congress, approved February 24, 1905 (33 Stat., 811), entitled "An Act to amend an Act approved August thirteenth, eighteen hundred and ninety-four, entitled 'An Act for the protection of persons furnishing materials and labor for the construction of public works,' " shall file with the obligee, at any time after a default in the performance of any contract subject to said Acts, the application and affidavit therein provided, the obligee shall not deliver to the obligor the deposited bonds nor any surplus proceeds thereof until the expiration of the time limited by said Acts for the institution of suit by such person or persons, and, in case suit shall be instituted within such time, shall hold said bonds or proceeds subject to the order of the court having jurisdiction thereof: *Provided further*, That nothing herein contained shall affect or impair the priority of the claim of the United States against the bonds deposited or any right or remedy granted by said Acts or by this section to the United States for default upon any obligation of said penal bond: *Provided further*, That all laws inconsistent with this section are hereby so modified as to conform to the provisions hereof: *And provided further*, That nothing contained herein shall affect the authority of courts over the security, where such bonds are taken as security in judicial proceedings, or the authority of any administrative officer of the United States to receive United States bonds for security in cases authorized by existing laws. The Secretary may prescribe rules and regulations necessary and proper for carrying this section into effect.

TITLE XIV—GENERAL PROVISIONS

Sec. 1400. (a) That the following parts of Acts are hereby repealed, subject to the limitations provided in subdivision (b):

(1) The following titles of the Revenue Act of 1916:

Title I (called "Income Tax");

Title II (called "Estate Tax");

Title III (called "Munitions Manufacturers' Tax"), as amended;

Title IV (called "Miscellaneous Taxes").

(2) The following parts of the Act entitled "An Act to provide increased revenue to defray the expenses of the increased appropriations for the Army and Navy and the extensions of fortifications, and for other purposes," approved March 3, 1917:

Title III (called "Estate Tax");

Section 402 (called "Returns of Dividends").

(3) The following titles of the Revenue Act of 1917:

Title I (called "War Income Tax");

Title II (called "War Excess-Profits Tax");

Title III (called "War Tax on Beverages");

Title IV (called "War Tax on Cigars, Tobacco, and Manufactures Thereof");

Title V (called "War Tax on Facilities Furnished by Public Utilities, and Insurance");

Title VI (called "War Excise Taxes");

Title VII (called "War Tax on Admissions and Dues");

Title VIII (called "War Stamp Taxes");

Title IX (called "War Estate Tax");

Title X (called "Administrative Provisions");

Title XII (called "Income-Tax Amendments").

(b) Such parts of Acts shall remain in force for the assessment and collection of all taxes which have accrued thereunder and for the imposition and collection of all penalties or forfeitures which have accrued and may accrue in relation to any such taxes, and except that the unexpended balance of any appropriation heretofore made and now available for the administration of any such part of an Act shall be available for the administration of this Act or the corresponding provision thereof: *Provided,* That, except as otherwise provided in this Act, no taxes shall be collected under Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917, or Title I or II of the Revenue Act of 1917, in respect to any period after December 31, 1917: *Provided further,* That the assessment and collection of all estate taxes, and the imposition and collection of all penalties or forfeitures, which have accrued under Title II of the Revenue Act of 1916 as amended by the Act entitled "An Act to provide increased revenue to defray the expenses of the increased appropriations for the Army and Navy and the extensions of fortifications, and for other purposes," approved March 3, 1917, or Title IX of the Revenue Act of 1917, shall be according to the provisions of Title IV of this Act. In the case of any tax imposed by any part of an Act herein repealed, if there is a tax imposed by this Act in lieu thereof, the provision imposing such tax shall remain in force until

the corresponding tax under this Act takes effect under the provisions of this Act.

Title I of the Revenue Act of 1916 as amended by the Revenue Act of 1917 shall remain in force for the assessment and collection of the income tax in Porto Rico and the Philippine Islands, except as may be otherwise provided by their respective legislatures.

Sec. 1401. That section 1100 of the Revenue Act of 1917 is hereby repealed, to take effect on July 1, 1919, and thereafter the rate of postage on all mail matter of the first class shall be the same as the rate in force on October 2, 1917: *Provided,* That letters written and mailed by soldiers, sailors, and marines assigned to duty in a foreign country engaged in the present war may be mailed free of postage, subject to such rules and regulations as may be prescribed by the Postmaster General.

Section 1107 of such Act is hereby repealed, to take effect July 11, 1919.

Sec. 1402. That if any clause, sentence, paragraph, or part of this Act shall for any reason be adjudged by any court of competent jurisdiction to be invalid, such judgment shall not affect, impair, or invalidate the remainder of this Act, but shall be confined in its operation to the clause, sentence, paragraph, or part thereof directly involved in the controversy in which such judgment has been rendered.

Sec. 1403. That the Revenue Act of 1916 is hereby amended by adding at the end thereof a section to read as follows:

"Sec. 903. That this Act may be cited as the 'Revenue Act of 1916.' "

Sec. 1404. That the Revenue Act of 1917 is hereby amended by adding at the end thereof a section to read as follows:

"Sec. 1303. That this Act may be cited as the 'Revenue Act of 1917.' "

Sec. 1405. That this Act may be cited as the "Revenue Act of 1918."

Sec. 1408. That every person who on or after April 6, 1917, has entered into any contract, undertaking, or agreement, with the United States, or with any department, bureau, officer, commission, board, or agency under the United States or acting in its behalf, or with any other person having contract relations with the United States, for the performance of any work or the supplying of any materials or property for the use of or for the account of the United States shall, within thirty days after a request of the Commission therefor, file

with the Commissioner a true and correct copy of every such contract, undertaking, or agreement.

Whoever fails to comply with such request of the Commissioner shall be guilty of a misdemeanor and shall be punished by a fine of not more than $1,000, or by imprisonment for not more than one year or both.

The Commissioner shall (when not violative of the technical military or naval secrets of the Government) have access to all information and data relating to any such contract, undertaking, or agreement, in the possession, control or custody of any department, bureau, board, agency, officer or commission of the United States, and may call upon any such department, bureau, board, agency, officer or commission for a full statement and description of any allowance for amortization, obsolescence, depreciation or loss, or of any valuation, appraisal, adjustment or final settlement, made in pursuance of any such contract, undertaking, or agreement.

Sec. 1409. That unless otherwise herein specially provided, this Act shall take effect on the day following its passage.

ACT OF JUNE 13, 1898 (30 STAT. 454), AS AMENDED BY ACT OF MARCH 2, 1901 (31 STAT. 940).[1]

Sec. 13. That any person or persons who shall register, issue, sell, or transfer, or who shall cause to be issued, registered, sold, or transferred, any instrument, document, or paper of any kind or description whatsoever mentioned in Schedule A of this Act, without the same being duly stamped, or having thereupon an adhesive stamp for denoting the tax chargeable thereon, and canceled in the manner required by law, with intent to evade the provisions of this Act, shall be deemed guilty of a misdemeanor, and upon conviction thereof shall be punished by a fine not exceeding fifty dollars, or by imprisonment not exceeding six months, or both, in the discretion of the court; and such instrument, document, or paper, not being stamped according to law, shall be deemed invalid and of no effect: *Provided*, That hereafter, in all cases where the party has not affixed to any instrument the stamp required by law thereon at the time of issuing, selling, or transferring the said bonds, debentures, or certificates of stock or of indebtedness, or any instrument, document, or paper of any kind or description whatsoever mentioned in Schedule A of this Act, and he or they, or any party having an interest therein, shall be subsequently desirous of affixing such stamp to said instrument, or, if said instrument be lost, to a copy thereof, he or they shall appear before the collector of internal revenue of the proper district, who shall, upon the payment of the price of the proper stamp required by law, and of a penalty of ten dollars, and, where the whole amount of the tax denoted by the stamp required shall exceed the sum of fifty dollars, on payment also of interest, at the rate of six per centum, on said tax from the day on which such stamp ought to have been affixed, affix the proper stamp to such bond, debenture, certificate of stock or of indebtedness or copy, or instrument, document, or paper of any kind or description whatsoever mentioned in Schedule A of this Act, and note upon the margin thereof the date of his

[1] These provisions are referred to in Chapter 47 on the Stamp Tax.

so doing, and the fact that such penalty has been paid; and the same shall thereupon be deemed and held to be as valid, to all intents and purposes, as if stamped when made or issued: *And provided further*, That where it shall appear to said collector, upon oath or otherwise, to his satisfaction, that any such instrument has not been duly stamped, at the time of making or issuing the same, by reason of accident, mistake, inadvertence, or urgent necessity, and without any wilful design to defraud the United States of the stamp, or to evade or delay the payment thereof, then and in such case, if such instrument, or, if the original be lost, a copy thereof, duly certified by the officer having charge of any records in which such original is required to be recorded, or otherwise duly proven to the satisfaction of the collector, shall, within twelve calendar months after the making or issuing thereof, be brought to the said collector of internal revenue to be stamped, and the stamp tax chargeable thereon shall be paid, it shall be lawful for the said collector to remit the penalty aforesaid and to cause such instrument to be duly stamped. And when the original instrument, or a certified or duly proven copy thereof, as aforesaid, duly stamped so as to entitle the same to be recorded, shall be presented to the clerk, register, recorder, or other officer having charge of the original record, it shall be lawful for such officer, upon the payment of the fee legally chargeable for the recording thereof, to make a new record thereof, or to note upon the original record the fact that the error or omission in the stamping of said original instrument has been corrected pursuant to law; and the original instrument or such certified copy, or the record thereof, may be used in all courts and places in the same manner and with like effect as if the instrument had been originally stamped: *And provided further*, That in all cases where the party has not affixed the stamp required by law upon any such instrument issued, registered, sold, or transferred at a time when and at a place where no collection district was established, it shall be lawful for him or them, or any party having an interest therein, to affix the proper stamp thereto, or, if the original be lost, to a copy thereof. But no right acquired in good faith before the stamping of such instrument, or copy thereof, as herein provided, if such record be required by law, shall in any manner be affected by such stamping as aforesaid.

Sec. 14. That hereafter no instrument, paper or document required by law to be stamped, which has been signed or issued without being duly stamped, or with a deficient stamp, nor any copy thereof, shall be recorded or admitted, or used as evidence in any court until a legal stamp or stamps, denoting the amount of tax, shall have been affixed thereto, as prescribed by law: * * *

Sec. 15. That it shall not be lawful to record or register any instrument, paper, or document required by law to be stamped unless a stamp or stamps of the proper amount shall have been affixed and cancelled in the manner prescribed by law; and the record, registry, or transfer of any such instruments upon which the proper stamp or stamps aforesaid shall not have been affixed and cancelled as aforesaid shall not be used in evidence.

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